



London
STOCK EXCHANGE

Corporate Governance

A PRACTICAL GUIDE



RSM! Robson Rhodes



London **STOCK EXCHANGE**

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series and believe that this Guide lives up to its name by providing some practical pointers on current good practice in this area.

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Foreword

BP has long recognised the importance of good governance and the pivotal role that the board plays in realising it. First, it is vital to understand what is meant by the term “corporate governance”. For us it means “the system by which the owners of the corporation ensure that it pursues, does not deviate from and only allocates resources to its defined purpose”. In a corporation that is a business, this defined purpose will be generating long-term shareholder value. To this end, boards are accountable for successfully governing and directing the corporation.

The foundations of world-class companies are laid in the boardroom. Companies need corporate governance policies that place the interests of their shareholders at the heart of the enterprise. In today’s world of regulation and best practice codes it would be easy to think that compliance was sufficient. Nothing should be further from the truth – though best practice is just that, one size does not fit all and true governance best practice must be tailored for the unique facets of each corporation.

This guide has been developed by the London Stock Exchange and RSM Robson Rhodes LLP. It provides practical guidance on corporate governance issues for board members and other interested parties alike. It acknowledges that addressing a corporation’s business purpose is critical while taking full account of the new regulatory and governance environment of the Combined Code on Corporate Governance for UK listed companies.

The guide covers a broad spectrum of issues from selecting and developing a high quality board and succession-planning to ensuring a board works effectively as a team. It goes on to explore a range of issues that a board must address if it is to enable the company to achieve its full potential including its input to strategy, effective risk management, communicating with shareholders and the development of an integrated approach to corporate social responsibility. It also discusses the work of board committees.

The effective stewardship of businesses entrusted to our care must remain high on the agenda of boards of all sizes and in all sectors. A successful economy depends on being able to build world-class companies which are leaders in the increasingly competitive global marketplace. Good governance is about enabling entrepreneurship and innovation within a framework of accountability. It demands sound judgement, high standards of probity and transparency in the relentless pursuit of the goals of the business.



Peter D Sutherland, KCMG

Chairman, BP p.l.c.

A guide for the boardroom

The primary purpose of this guide is to help boards of listed companies to lead and direct their businesses successfully. It strives to provide practical insights into best practice on boardroom effectiveness so as to help boards achieve their strategic objectives and build enduring value in their businesses.

The guide takes account of the principles and provisions of the new Combined Code on Corporate Governance, applicable for financial periods beginning on or after 1 November 2003 to all UK incorporated companies listed on the London Stock Exchange. It also includes reference to other authoritative guidance.

Under the current listing rules, listed companies have to report on how they have applied the principles in the Code although the form and content of this part of their disclosure statement are not prescribed. Companies also have either to confirm that they comply with the Code's provisions or provide an explanation of any departures from them. It is expected that companies will normally comply with the provisions but recognised that departure may be justified in particular circumstances. The preamble to the Code emphasises that an evaluation of a company's governance should pay due regard to its individual circumstances including its size and the complexity of its business along with the risks and challenges it faces.

It is intended that companies quoted on AIM should also find this guide a useful resource though the Combined Code does not formally apply to them.

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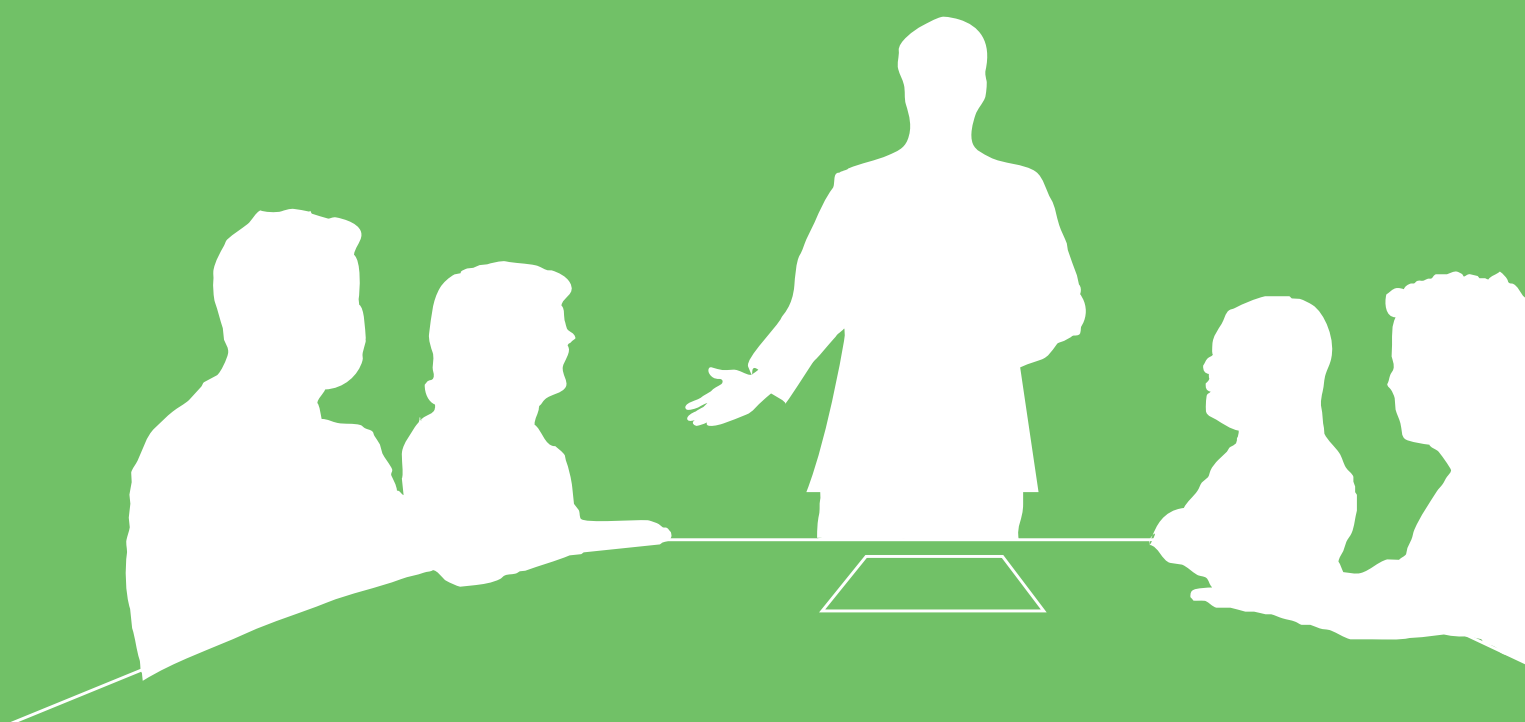
Corporate Governance

A PRACTICAL GUIDE

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The effective board

- ▶ Does the board have clear objectives and monitor its performance against them?
- ▶ Is the board focusing on the correct areas for its decision-making?
- ▶ Is the chairman leading the board effectively?
- ▶ Does the board provide a challenging yet supportive environment for the executive directors? Is there a full discussion before major decisions are taken?
- ▶ Is the board meeting schedule suitable for the needs of the business? Does the board receive board papers of the right length and quality? Are they provided in a timely manner?
- ▶ How have key board decisions turned out? How could the decision-making process be strengthened for the future?
- ▶ Is there a thorough boardroom appraisal process with a follow-up action plan?



The effective board

“Every company should be headed by an effective board, which is collectively responsible for the success of the company. The board’s role is to provide entrepreneurial leadership of the company within a framework of prudent and effective controls which enables risk to be assessed and managed. The board should set the company’s strategic aims, ensure that the necessary financial and human resources are in place for the company to meet its objectives and review management performance. The board should set the company’s values and standards and ensure that its obligations to its shareholders and others are understood and met”.

These opening principles of the new Combined Code on Corporate Governance ('the Code') highlight the board’s responsibility for leading and directing the company. The quest for world-class performance in the business must start in the boardroom. A summary of the specific provisions in the Code dealing with the functioning of the board is set out in Figure 1.1.

Leadership by the chairman

The chairman has a pivotal role to play in helping the board achieve its full potential. He or she is responsible for the leadership of the board, setting its agenda and ensuring its effectiveness. The chairman must facilitate effective contributions by the non-executive directors and ensure that there is a constructive relationship between them and the executive directors. The unitary board structure in the UK – with its mix of executive and non-executive directors on the board – makes the nature of those relationships absolutely crucial to an effective board.

In his book *Letters to a New Chairman*,⁽¹⁾ Hugh Parker says that the 'intangible quality of personal leadership' provided by the chairman is the one factor above all others that influences the effectiveness of any board. He believes that key elements of that leadership include having a sense of what he or she wants the organisation to do and become in the next five to ten years; a clear and definable set of objectives; strong personal views on how the company should seek to achieve those objectives; and, last but not least, real personal authority.

Figure 1.1 The board in action

Key provisions of the Combined Code

- ▶ **The board should meet sufficiently regularly to discharge its duties effectively. There should be a formal schedule of matters specifically reserved for its decision.**
- ▶ **Directors should receive accurate, timely and clear information. Management should provide such information but directors should seek clarification/amplification.**
- ▶ **The chairman should ensure that the directors continually update their skills and have the knowledge and familiarity with the company required to fulfil their role on the board and its committees.**
- ▶ **The chairman should ensure that the views of shareholders are communicated to the board as a whole. The chairman should discuss governance and strategy with major shareholders.**
- ▶ **The chairman should hold meetings with the non-executive directors without the executives present.**
- ▶ **The board should undertake a formal and rigorous annual evaluation of its own performance and that of its committees and individual directors.**
- ▶ **Where directors’ concerns about the running of the company or a proposed action cannot be resolved they should ensure that they are recorded in the board minutes.**

Source: Extracted from The Combined Code on Corporate Governance, 2003 (abridged)

Meanwhile, Sir Adrian Cadbury has likened the chairman's role⁽²⁾ to being the conductor of an orchestra. He reflects that 'taking the chair at board meetings is the aspect of the job of chairman which is furthest from the public eye, but the one where their personal contribution is decisive'. The chairman must strike the balance between controlling the discussion in order to keep it to the point while encouraging board members to contribute to the debate.

Non-executive directors

The Code calls on non-executive directors to:

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

Some of their duties will be performed on the board, others in board committees made up wholly – or mainly – of non-executive directors. The new Code indicates that the chairman should hold some meetings solely with the non-executive directors. In turn, the non-executive directors should meet at least once a year without the chairman present in order to appraise his or her performance. Those meetings with a non-executive focus should be included in the board's regular schedule to reduce the risk of executive directors worrying that they are excluded from certain meetings. In addition to formal meetings, the whole board and the non-executive directors as a group should meet informally on a periodic basis in order to improve their ability to work together as a team.

The efficient working of the board

Figure 1.2 sets out a number of issues that may help boards make their meetings more productive. The framework of issues that the board should consider are as set out at the beginning of this chapter. As part of its responsibilities for strategy and resources, the board should approve acquisitions and other major capital expenditure decisions, the financing of the business, and budgets and forecasts.

Figure 1.2 Successful board meetings

Some areas to consider:

- ▶ **The board agenda should strike a balance between long-term strategic and shorter-term performance issues. All directors should have the opportunity to put items on the agenda.**
- ▶ **Agenda topics should be supported by concise, informative papers with key points highlighted. Alternative courses of action should be proposed where relevant and the risks associated with proposed decisions should be noted and discussed.**
- ▶ **Ensure that papers are distributed in good time.**
- ▶ **Hold regular meetings including strategy away days.**
- ▶ **High attendance at meetings should be expected and achieved.**
- ▶ **Directors should come to meetings well prepared.**
- ▶ **The chairman should focus discussion around the principal issues in each agenda paper.**
- ▶ **All board members should feel able to contribute at meetings and do so.**
- ▶ **Major decisions should only be taken after a full discussion at board meetings.**

(Issues based on current good practice)

A recent survey of large listed companies⁽³⁾ reveals that most boards meet between eight and ten times each year – inclusive of strategy days, which can be a very valuable addition to the more routine meetings. Directors will find themselves subject to increased pressure to attend board and committee meetings in the future since the new Code requires that individual director attendance is publicly disclosed. This requirement and other considerations should be borne in mind when meetings are being arranged though the meeting schedule will obviously have to fit around calendar requirements such as the publication dates for interim and final results. The chairman also needs to ensure that arrangements have been put in place to allow for discussion among directors between meetings, for example, by telephone, teleconferencing or e-mail.

Information available to the board

The board needs information from inside and outside the company to enable it to monitor and review effectively the company's performance against its strategic objectives. This information

should embrace financial and non-financial measures of performance, taking proper account of the company's own performance and prospects and how they compare to its principal competitors and the market leaders. The board should have a dashboard comprising a limited number of key performance measures with demanding targets against which to assess progress. In doing so, it should be careful to avoid excessive focus on short-term performance at the expense of a more broad-based understanding of the company's longer-term positioning.

Non-financial measures of performance might include:

- ▶ market positioning of key brands;
- ▶ customer satisfaction/retention;
- ▶ employee satisfaction and turnover;
- ▶ proportion of business attributable to new customers/products;
- ▶ R&D and innovation measures;
- ▶ social and environmental performance;
- ▶ shareholder and other key stakeholder assessments of the business.



Figure 1.3

Performance evaluation of the board

- ▶ Has the board met its performance objectives?
- ▶ What has been the board's contribution to the testing and development of strategy?
- ▶ What has been the board's contribution to robust and effective risk management?
- ▶ Is the composition of the board and its committees appropriate? Does it have the right mix of knowledge and skills to maximise performance in the light of future strategy? Are the board's relationships inside and outside the boardroom working effectively?
- ▶ How has the board responded to any problems or crises that have emerged? Could or should these have been foreseen?
- ▶ Are the right matters being reserved for the board?
- ▶ How well does the board communicate with the management team, employees and others? How effectively does it use mechanisms such as the AGM and the annual report?
- ▶ Is the board up to date with the latest developments in the regulatory environment and the market?
- ▶ How effective are the board's committees? Does each committee have the right composition? How do they interact with the main board? Do they fulfil their role?

Source: *Related Guidance and Good Practice Suggestions, The Combined Code on Corporate Governance, 2003 (abridged)*

Performance evaluation and development

Human resources' best practice will no longer stop at the boardroom door: the new Code indicates that the board should undertake a 'formal and rigorous' evaluation of its own performance and that of committees and individual directors. At present, about two-thirds of companies undertake some form of collective board assessment⁽⁴⁾ but even some of those are likely to review and strengthen their existing processes in the light of the wording in the new Code.

Good Practice Suggestions appended to the Code outline a series of questions to assist boards in assessing their performance and in

identifying possible areas for future development (see Figure 1.3). The guidance also contains some questions on board procedures and on the chairman's contribution to the effective functioning of the board.

Boards will obtain the most out of their evaluation if they have set themselves objectives against which their performance can be measured. They will find it helpful to look back at some key decisions the board has taken in the past year to consider what can be learnt from them for the future. Was the information presented to the board at the time the best available? Would further analysis have been helpful? Bearing in mind what is known now, how well did the board address the main issues? Focusing on the challenges ahead will be equally, if not more,

valuable. The board should think about how it needs to approach those challenges if it is to maximise the chances of achieving its goals. A number of boards are using questionnaires to identify issues for discussion. They should concentrate on those issues where most of the board consider improvement is needed or where there is a divergence of view among board members.

The evaluation should also consider how well the board works as a team. Is constructive challenge welcomed or is it seen as dissent? Does it feel like a unitary board or is there evidence of different factions? Are there any dominant players that might – even accidentally – be restricting the contribution of others? Some boards may find it useful to involve an external facilitator in the evaluation process. The facilitator can manage the

information-gathering process and talk to individual board members to discover key issues for discussion. The external input can help raise issues that may not emerge if it was a purely internal process. Other boards may, however, feel more comfortable in having a private discussion on their collective performance. Whichever path is followed, the board should develop an action plan with set timescales to ensure changes are implemented as part of a process of continual improvement in the boardroom.

Boards may find it helpful to look at the chart (Figure 1.4) showing seven types of board - an effective board and six less successful variants. Each board should consider which unsuccessful elements it possesses – it may be more than one – and how it can best steer back towards the most effective model.



Figure 1.4

Board Games:

Common features of seven types of board - The effective board and those not achieving their full potential



Source: © 2004, RSM Robson Rhodes LLP

Figure 1.5

Individual evaluation of non-executive directors

- ▶ How well prepared and informed are the non-executive directors for board meetings? Is their meeting attendance satisfactory?
- ▶ Do they demonstrate a willingness to devote time and effort to understand the company and its business? Do they have a readiness to participate in events outside of the boardroom such as site visits?
- ▶ What has been the quality and value of their contributions at board meetings?
- ▶ How successfully have they contributed to strategy development and risk management?
- ▶ How effectively have they tested the information and assumptions with which they are provided? How resolute are they in maintaining their own views and resisting pressure from others?
- ▶ How effectively and proactively have they followed up on any areas of concern?
- ▶ Does their performance and behaviour engender mutual trust and respect within the board?
- ▶ How actively and successfully do they refresh their knowledge and skills? Are they up to date with market and regulatory developments?
- ▶ Are they able to present their views convincingly yet diplomatically? Do they listen and take on board the views of others?

Source: Relevant Guidance and Good Practice Suggestions, The Combined Code on Corporate Governance, 2003 (abridged)

Most non-executive directors will not have previously been subject to individual assessment. The *Good Practice Suggestions* include proposed questions that might help form a template for discussion between the chairman and each non-executive on their performance (Figure 1.5). In certain circumstances the chairman may also provide constructive feedback offered by other directors. A balance needs to be struck though between a thorough evaluation and jeopardising the way in which the board works as a team.

It is the board's responsibility to review the effectiveness of its committees. Each committee should undertake its own performance evaluation but board members who are not on a particular

committee should also have the chance to contribute to the process. The results and follow-up plans should be approved by the whole board.

Performance evaluations will provide useful insights into the training and development needs of the board and its individual directors. This has traditionally not been an area of high priority for many boards but the Code stipulates that new directors should receive a 'full, formal and tailored induction' on joining the board. All directors are expected to continually update their skills, knowledge of, and familiarity with, the company. As a result, many more boards are likely to want to establish board development and briefing programmes in the future.

Disclosure

In the past, the disclosures about the board have largely centred on who is chairman, CEO and senior independent director; the names of board members serving on particular committees; and remuneration issues. The new Code goes much further and calls for the following additional disclosures:

- ▶ a statement of how the board operates, including a high level statement of which types of decisions are taken by the board;
- ▶ details of the number of meetings of the board/committees and individual attendance by directors;
- ▶ discussion of how performance evaluations have been conducted;
- ▶ disclosure of steps taken to ensure members of the board develop an understanding of the views of major shareholders about the company.

A light is being shone into the boardroom to highlight how it operates as well as how it is constituted. Boards will find, consciously or otherwise, that they are providing insights into how they are discharging their responsibility for stewardship of the company. The information provided will be closely analysed by institutional shareholders and other stakeholders.



References

- (1) Hugh Parker, *Letters to a New Chairman*, Institute of Directors, 1990
- (2) Sir Adrian Cadbury, *Corporate Governance and Chairmanship: A Personal View*, Oxford University Press, 2002
- (3) Spencer Stuart, *2003 UK Board Index*
- (4) *Research study conducted by MORI for the Higgs Report – Review of the role and effectiveness of non-executive directors, 2003*

Building a talented board

- ▶ What are the board's strengths and weaknesses?
- ▶ Is there a strong presence on the board of both executive and independent directors?
- ▶ Is there sufficient diversity among board members?
- ▶ What do institutional investors and other key stakeholders think of the board?
- ▶ What new skills and experience will be needed to enable the board to achieve its goals in the future?
- ▶ Is there effective succession planning for board and senior management appointments?
- ▶ Is there a formal, rigorous and transparent process in place for selecting new directors?



Building a talented board

Building a talented board is a cornerstone of an effective corporate governance system. Following best practice on effective board meetings will be worth very little if you do not have the right people on the board in the first place. Recognising this, the new Code contains significant changes in relation to board appointments that may alter the shape of many boards over time. It includes a number of additional provisions relating to board structure and composition but the extent to which they will have their intended impact will be dependent upon the initial selection of board members. Their collective skills, experience and approach to running the business should make them the best suited to driving it forward and achieving the company's goals. The process for selecting new directors will require significant attention by the board and its nomination committee. Currently, only 32% of respondents to the *Board Effectiveness Survey*⁽¹⁾ agree that their boards have a rigorous independent process in place for selecting non-executive directors.

Board composition

For the first time the new Code draws a distinction between the number of independent directors that are expected to be on the boards of different sizes of listed company. For FTSE 350 companies, at least half the board (excluding the chairman) should comprise non-executive directors who are deemed independent. The boards of other listed companies should include at least two independent non-executive directors. This new two-tiered provision replaces the earlier one calling on at least a third of the board to be made up of non-executive directors, a majority of whom should be independent. The Code now includes a set of criteria that 'may appear relevant' in determining a director's independence (see Figure 2.1). The board may decide that a director is independent despite the existence of one of the specified relationships or circumstances but should then explain its reasons for doing so.

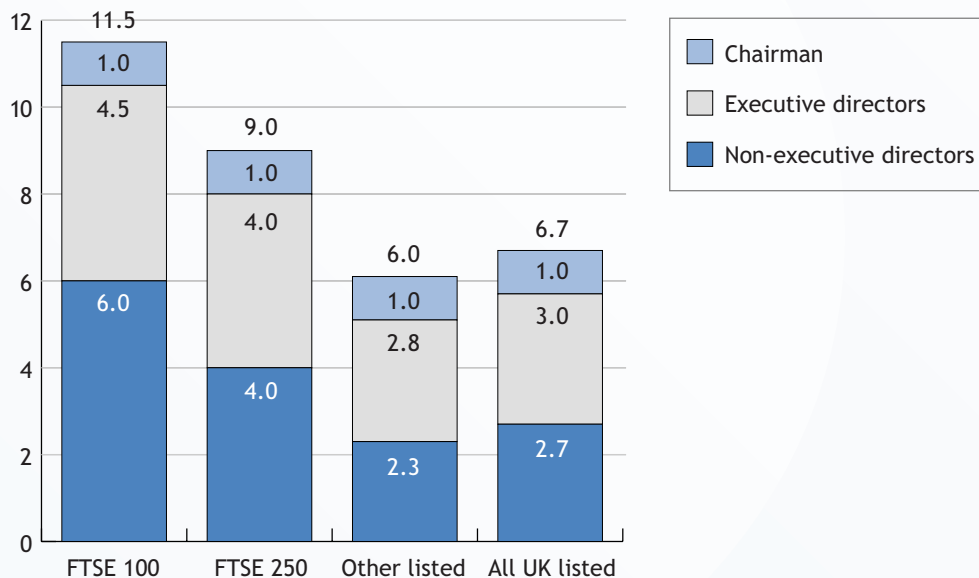
Figure 2.1

Reasons for challenging the independence of a director

- ▶ Has been an employee of the group within the last five years
- ▶ Has had a material business relationship with the company within the last three years
- ▶ Received/receives additional remuneration apart from director's fee; is in company share option or performance-related pay scheme; or a member of the company's pension scheme
- ▶ Has close family ties with any of the directors, senior employees or advisers
- ▶ Holds cross-directorships/has significant links with other directors
- ▶ Represents a significant shareholder
- ▶ Has served on the board for more than nine years

Source: *The Combined Code on Corporate Governance, 2003 (abridged)*

Figure 2.2
Average board size and composition



*Figures may not add up due to rounding
 Source: The Higgs Report – NEDs Review team analysis, 2003*

The Code emphasises that the board should be of a sufficient size so that its members' skills and experience are appropriate for the needs of the business. The board's size should also allow it to change its composition without undue disruption. At the same time, it should not be so large as to be unwieldy and there should be a strong presence on the board of both executive and non-executive directors. Given that executive directors already comprise, on average, less than half the membership of most FTSE 350 boards (see

Figures 2.2 and 2.3), these new provisions in the Code are unlikely to result in the hiring of large numbers of new independent directors. They are, however, likely to lead to high-profile challenges from institutional investors as to the independence of some long-serving, non-executive directors.

Figure 2.4 provides an overview of the current composition of the boards of UK plc.

Figure 2.3
Average size of boards

	FTSE 100	FTSE 250	Other listed
Executive Directors	3-6	2-5	2-4
Non-executive Directors	4-6	3-5	1-3
Total	9-12	7-10	5-7

*NB: NEDs/Executive Directors figures exclude Chairmen
 Source: The Higgs Report - NEDs Review team analysis, 2003*

Figure 2.4

Composition of boards of UK listed companies

Over 80% of those holding NED posts in UK listed companies hold one such post; comparative figure for chairmen is nearly 90%

Average age of FTSE 100 directors:

	Years
Chairmen	62
NEDs	59
CEOs	54
Executive Directors	51

Proportion of UK listed directorships held by women:

	FTSE 100	All listed
Chairmen	1%	1%
NEDs	11%	6%
Executive Directors	2.5%	4%

Source: The Higgs Report - NEDs Review team analysis of data, 2003

The chairman

The new Code clearly states that the roles of chairman and CEO should be split, with the division of responsibility between them clearly agreed and set out in writing. Research in 2003 showed that only 5% of FTSE 100 companies, 4% of FTSE 250 companies and 11% of other smaller listed companies still combined these positions.⁽²⁾ All of those companies that fall into this group and that have institutional shareholders can expect continued pressure to have a separate chairman and CEO.

Upon his or her appointment the chairman should now satisfy the independence criteria set out in the Code. There is also a new provision that, save in exceptional circumstances, the chief executive should not go on to become chairman of the

board, a relatively frequent occurrence until now. As a result, more boards are now likely to draw their future chairmen from among their independent board members. This is a factor that will need to be taken into account when selecting non-executive directors and when allocating them their subsequent board responsibilities.

Senior independent director

The Code advises that the board should appoint one of the independent non-executive directors to be the senior independent director. He or she should be available to shareholders to discuss concerns that they are unable to resolve through the normal channels of contact with the chairman, CEO or finance director. The senior independent director will also chair meetings of non-executive directors when the board chairman is not present.

New board appointments

The board's nomination committee should evaluate the balance of skills, knowledge and experience of the board and, in light of this, prepare a description of the role, experience and skills required for a particular new appointment. This should be done as part of a routine succession planning process, designed to ensure that plans are in place for orderly succession to the board and other senior management positions. On the executive side, this is likely to involve key individuals being given opportunities to gain a breadth of experience within the business and to be visible to the board if they are not yet a member of it. The Conference Board has highlighted the main features of a successful succession planning process ⁽³⁾ (see Figure 2.5).

Looking at how an appointment will strengthen the board as a whole rather than considering each vacancy in isolation is welcome. There are plenty of examples in corporate history where highly talented individuals did not work well together as part of a team – to the detriment of all involved.

The nomination committee

The nomination committee has the responsibility for leading the process for board appointments and making recommendations to the board accordingly. A majority of its members should be independent non-executive directors. One of those independent non-executive directors or the chairman of the board should chair the nomination committee. An important point to note in the latter case: the board chairman should not lead the search for his or her own successor. For smaller listed companies with only two independent directors there would seem to be merit in having the company chairman on the committee as the third member in order to facilitate discussion among committee members.

The question of whether the company chairman should be permitted to chair the nomination committee was the subject of much discussion when the Code was being drafted. Given the chairman's responsibility for leading the board, a strong case can be made for his or her involvement in the committee alongside

independent directors. That case is strengthened by the fact that the roles of the majority of chairmen are non-executive in nature.

Whereas the previous version of the Code discussed the need for a 'formal and transparent' procedure for the appointment of board members, the new Code has crucially added the word 'rigorous'. The earlier version of the Code also allowed companies with a small board – irrespective of the size of the company – to avoid the need for a nomination committee. That flexibility has now disappeared. As a result, many smaller listed companies will wish to establish a nomination committee in order to take on the detailed responsibilities allocated to it within the new Code. Last year, only 6% of FTSE 100 companies and 19% of FTSE 250 companies did not have a nomination committee but 71% of smaller company listed boards had yet to establish one. ⁽²⁾

Figure 2.5 Elements of a good succession planning process

- ▶ **A continuous process**
- ▶ **Driven and controlled by the board**
- ▶ **Involves CEO input**
- ▶ **Easily executable in the event of a crisis**
- ▶ **Considers succession requirements based on corporate strategy**
- ▶ **Geared towards finding the right leader at the right time**
- ▶ **Develops talent pools at lower levels**
- ▶ **Avoids a 'horse race' mentality that may lead to loss of key deputies when the new CEO is chosen**

Source: The Combined Code on Corporate Governance, 2003 (abridged)

Institutional investors and other stakeholders are increasingly focusing their attention on the quality of the board as a whole - including the independent directors - rather than just the management team and the chairman. The views of shareholders and other stakeholders will therefore be valuable to nomination committees as they seek to determine the board's strengths and areas for improvement. As such, nomination committees should ensure that they can easily access feedback from the financial community and other audiences. Comparing the board's composition relative to its main competitors and understanding the reasons for any substantial differences will also be worthwhile.

Issues for the nomination committee to address in evaluating the board's skills and experience will include:

- ▶ *Is the board reasonably diverse or does it run the risk of thinking in too uniform a fashion?*
 An overly homogeneous board can provide an insufficiently challenging environment for decision-making - a highly risky approach in today's fast changing business world. The board needs to be properly balanced to enable it to address the current and, in particular, future challenges of the business. There should be a mix of personality types so that there is lively discussion of issues with alternative courses of action considered. This requires the independent directors to strike the right balance between being challenging yet supportive of the executive team. Care should be taken to avoid different factions emerging. If this does happen some change in membership might be helpful. The board should have the right functional expertise, for example in finance, marketing, and people issues, but should also be able to give appropriate weight both to strategic and shorter-term tactical issues. There needs to be a good understanding of customers' needs along with the ability to engage the commitment of the workforce and to communicate effectively with shareholders. Groups that are still frequently under-represented include directors based in key markets outside the UK, women, younger directors, and those from ethnic minority backgrounds.

- ▶ *Does the board possess the in-depth experience necessary for the work of its committees?*

The Code specifically calls for one member of the audit committee to have 'recent and relevant financial expertise'. However, questions about appropriate expertise should begin rather than end there. The remuneration and nomination committees are increasingly in the public eye and more boards may find it helpful to have a non-executive director with a human resources background to respond to these developments.

- ▶ *Is there a particular type of expertise that the board would find helpful in the future?*

If a board knows that it will face a specific challenge in the near future but lacks the relevant expertise around the table it may be worth recruiting a non-executive with experience or skills in that field. That individual can then provide advice to the board as it moves forward. Examples may include a decision to improve corporate social responsibility performance, undergoing a major change management programme, growing new international markets, or planning an acquisition programme

- ▶ *Is the board being regularly refreshed?*

The Code officially suggests that non-executive directors' independence comes into question after nine years. Despite this, many commentators would argue that two terms of three years each should be the normal benchmark for a non-executive director.

When new appointments need to be made, consideration should be given as to how they can best be phased in to ensure the smooth running of the board. Forward planning of this nature will be valuable if there is a perceived imbalance in the existing range of skills, experience or personalities represented on the board; problems related to the contribution of an individual board member; or simply a desire to keep a winning team refreshed. A description of the role and the desirable attributes for the new director should be prepared – this will help determine the form the search for the candidates will take and, for example, which headhunters or media outlets to use. A list of generally desirable characteristics for board members is shown at Figure 2.6.

The Code calls for the company's annual report to disclose if neither an external search consultant nor open advertising has been used in the appointment of a chairman or of non-executive directors. This requirement highlights the expectation that informal contacts should not be the only means of identifying possible candidates. Smaller listed company boards, in particular, may find that thinking creatively about how to source candidates for non-executive appointments will pay dividends. They may find it helpful, for instance, to access registers held by a number of professional bodies or to approach leaders of successful unquoted businesses. Other tactics include building links with larger listed companies in the area which may be interested in enabling their high flyers to gain boardroom experience, recruiting those on career breaks from market leaders, or sourcing directors who have recently stepped down from senior executive positions.

Time available

The new Code makes it clear that companies should take steps to ensure that a potential chairman or non-executive director has sufficient time to undertake their duties. Those duties extend well beyond just attending meetings. They may include participating in site visits and relevant company activities, keeping up-to-date with developments in the company and the sector, and allowing time for adequate preparation for meetings. When appointing a chairman, an assessment of the expected time commitment should be set out in the job specification, including recognition of their need for availability in crises. The board should be made aware of a candidate's other commitments before any appointment is made and those details should then be disclosed in the next annual report once selection is confirmed.

References

- (1) RSM Robson Rhodes LLP and the London Stock Exchange, *Board Effectiveness Survey, How does your board shape up? General results report, October 2003*
- (2) *The Higgs Report, NEDs Review team analysis of data supplied by Hemscott, 2003*
- (3) *Corporate Governance Best Practices, A Blueprint for the Post-Enron Era, Conference Board, 2003*

Widening the pool

The new Code addresses the frequently raised concern that non-executive directors have often been drawn from a narrow pool based on existing directors' contacts. The aim of the measures set out in it is to ensure that board appointments are made on merit and against set objectives. Just as importantly, the requirements help stakeholders to verify that this has been the case via improved disclosure. Getting the appointment process right is important as it determines how effectively the board will function in the future. It will be most successful if the board and nomination committee are prepared to devote the necessary time and commitment to the selection of new board members.

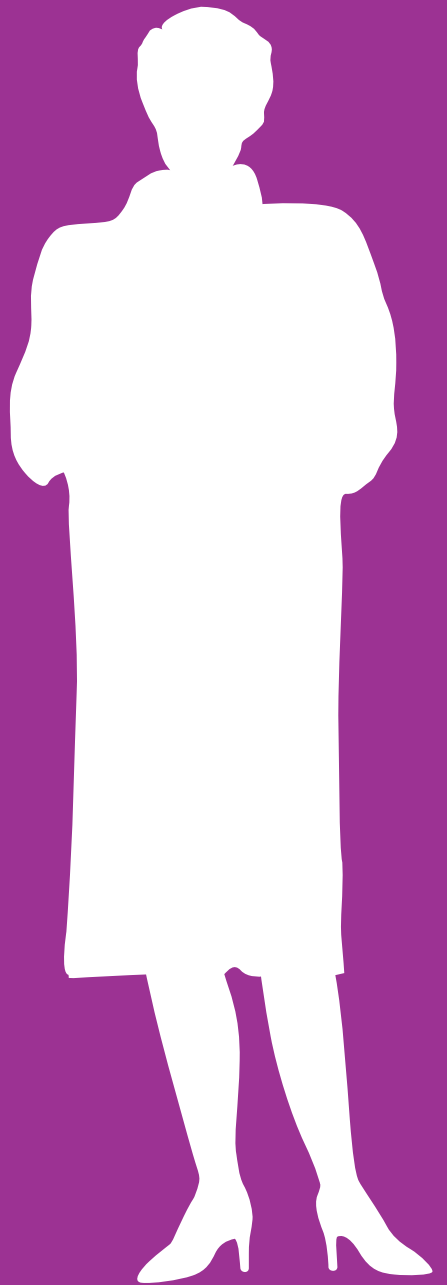
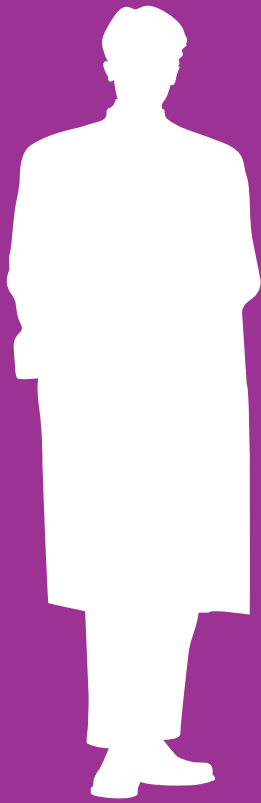
Figure 2.6 Behavioural characteristics of a good director

- ▶ Asks the difficult questions
- ▶ Works well with others
- ▶ Has industry awareness
- ▶ Provides valuable input
- ▶ Is available when needed
- ▶ Is alert and inquisitive
- ▶ Has business knowledge
- ▶ Contributes to committee work
- ▶ Attends meetings
- ▶ Speaks out appropriately at board meetings
- ▶ Prepares for meetings
- ▶ Makes long-range planning contribution
- ▶ Provides overall contribution

Source: Corporate Governance Best Practices, Conference Board, 2003

Tying remuneration closely to performance

- ▶ Is the policy on directors' remuneration in line with guidance in the Code and with guidelines of relevant institutional investors' organisations? Are the institutional shareholders supportive of the company's remuneration policy?
- ▶ Has executive directors' pay and performance been fairly compared with that of a properly chosen peer group?
- ▶ Are targets set for bonuses and long-term incentive payments such that high rewards are only available for outstanding performance?
- ▶ Does the remuneration committee thoroughly assess whether the targets have been met before making awards?
- ▶ Are there any contract periods for executive directors in excess of one year? If so, can they be justified?
- ▶ Are arrangements in place to ensure that the company does not reward failure when directors leave early owing to poor performance?
- ▶ Is there a high level of transparency in publicly explaining how remuneration has been determined?



Tying remuneration closely to performance

'Levels of remuneration should be sufficient to attract, retain and motivate directors of the quality required to run the company successfully, but a company should avoid paying more than is necessary for the purpose. A significant proportion of executive directors' remuneration should be structured so as to link rewards to corporate and individual performance'.

While this principle in the Code enjoys broad support in the business community, controversy is likely to remain in relation to its implementation in particular cases. Among the issues attracting most attention are the extent to which there is a robust linkage between performance and remuneration; avoiding rewards for failure; and transparency of remuneration, both when arrangements are being put in place and once they have been agreed.

Composition and role of remuneration committee

The Code calls on listed companies to have a remuneration committee wholly made up of independent non-executive directors. FTSE 350 companies are expected to have a minimum of three members on their committee whereas smaller listed companies are allowed to have just two. The remuneration committee has responsibility for determining the remuneration for all executive directors and the chairman on behalf of the whole board. The committee also recommends and monitors the level and structure of remuneration for senior management, at least for the first layer below board level. The board itself should normally determine the non-executive directors' remuneration.

ABI Principles on Remuneration

The Association of British Insurers (ABI), whose members hold around 20% of the shares in UK listed companies, has issued *Principles and Guidelines on Executive Remuneration*.⁽¹⁾ These are consistent with the Code and provide a

practical framework to help companies in determining their remuneration policy and shareholders in making their voting decisions. The principles call on remuneration committees to maintain 'a constructive and timely' dialogue with their major institutional shareholders and the ABI on remuneration issues. They also suggest that any departure from the stated remuneration policy should be the subject of prior shareholder approval.

The principles state that boards should demonstrate that performance-based remuneration arrangements are clearly aligned to business strategy and objectives, regularly reviewed and in line with current best practice. The ABI points out that simple remuneration structures assist with motivation and enhance the prospects of successful communication with the employees involved and with shareholders. Shareholders should also have their attention drawn to any special arrangements and significant changes since the previous remuneration report.

The *ABI Guidelines on the Structure of Remuneration*⁽¹⁾ call for companies to justify their actions if they are seeking to pay salaries over and above median levels. This is designed to avoid a continual upward ratchet effect on directors' remuneration which is inevitable if most companies aim to pay above the median benchmark. Setting base salary levels below the comparator group median provides more headroom for increasing performance-related pay. The guidelines also stress that shareholders do not support transaction bonuses as these provide rewards irrespective of the future financial outcomes of such deals.

Performance-related remuneration

The main provision in the Code on performance-related elements of remuneration indicates that they should align executive directors' interests with those of shareholders and give them 'keen incentives to perform at the highest levels'. More detailed provisions set out how this should be achieved. On annual bonuses, for example, the Code states performance conditions should be 'relevant, stretching and designed to enhance shareholder value'. Upper limits should be set and

disclosed. The *ABI Guidelines for the Structure of Remuneration*⁽¹⁾ indicate that annual bonuses - which it notes will normally be payable in cash - can provide useful short-term incentivisation. It suggests that both individual and corporate

performance targets are relevant in setting annual bonuses.

The key elements of the Code and the relevant ABI guidelines dealing with share incentive schemes are summarised at Figure 3.1.

Figure 3.1

Share-based incentive schemes - some key elements

Combined Code provisions

- ▶ Shares granted or other forms of deferred remuneration should not vest, and options should not be exercisable, in less than three years. Directors should be encouraged to hold their shares for a further period after vesting or exercise, subject to the need to finance any costs of acquisition and associated tax liabilities.
- ▶ Any proposed new long-term incentive schemes should be approved by shareholders.
- ▶ Payouts or grants under all incentive schemes should be subject to challenging performance criteria reflecting the company's objectives. Consideration should be given to criteria that reflect the company's performance relative to a group of comparator companies in some key variables such as total shareholder return.
- ▶ Grants under incentive schemes should normally be phased rather than awarded in one block.
- ▶ The pension consequences and associated costs of base salary increases/other changes in pensionable remuneration should be considered especially carefully in the case of directors who are close to retirement. In general, only salary should be pensionable.

Some additional elements in the ABI Guidelines for Share Incentive Schemes

- ▶ Overall dilution under all schemes should not exceed 10% in any rolling ten year period. As a general rule, commitments under executive (discretionary) schemes should not exceed 5% of the issued share capital over a similar period.
- ▶ Vesting of awards should be conditional on meeting challenging performance conditions related to overall corporate performance.
- ▶ Total shareholder return relative to a relevant index/peer group is one of a number of generally acceptable performance criteria.
- ▶ Share-based performance awards should not be made for less than median performance. Initial vesting levels should not be significant in relation to annual salary. Where an annual amount exceeds one times salary, a clear explanation of the stretching nature of the performance criteria should be provided.
- ▶ Shareholders welcome the trend towards sliding scale awards related to the achievement of demanding and stretching financial performance against a target group or other relevant benchmark.
- ▶ Performance conditions should be measured over a period of three or more years. Strong encouragement is given to using periods of more than three years. There should be no automatic waiving of performance conditions in the event of a change of control or capital reconstruction.
- ▶ Schemes should be designed to encourage share retention so that directors build-up/maintain meaningful holdings in the context of their remuneration.

Source: Extracted from Combined Code on Corporate Governance, 2003 and ABI Guidelines for Share Incentive Schemes, 2003 (abridged)

Boards will also need to take account of the impact of the International Financial Reporting Standard on *Share-based Payment (IFRS 2)*.⁽²⁾ This will be applicable to listed companies' consolidated accounts for periods beginning on or after 1 January 2005 and is also being incorporated into UK GAAP. The standard requires a charge to be made to the profit and loss account in respect of the expense associated with share-based payments and may well have the effect of leading to more cash-based incentive schemes. It is also retrospectively applicable to grants of shares or share options from November 2002 that have not vested with the directors or other staff prior to 2005.

Not rewarding failure

Large pay-offs for departing executives in poorly performing companies have featured prominently in the business media for many years. Institutional shareholders also find them a real cause for concern.

The Code indicates that remuneration committees must carefully consider the total compensation commitments their company would have in the event of early termination of directors' contracts – including those relating to pension contributions. The aim is to avoid rewarding poor performance and the remuneration committee should take 'a robust line' on reducing compensation to reflect the departing director's obligation to mitigate loss.

The provision in the Code covering notice or contract periods has been strengthened. They should be one year or less and where it is necessary to offer longer periods to new directors recruited from outside the company they should reduce to no longer than one year after the initial period.

The ABI and the National Association of Pension Funds (NAPF) have produced a statement of best practice on executive contracts and severance that amplifies the guidance in the Code. Key elements of the guidance are shown in Figure 3.2.

Non-executive directors' remuneration

The Code states that the remuneration of non-executive directors should reflect their time commitment and responsibilities. The Smith Report on audit committees, appended to the Code, goes on to suggest that the remuneration of audit committee members may warrant particularly careful review in light of the now more demanding nature of the role. It says that 'consideration should be given to the time members are required to give to audit committee business, the skills they bring to bear and the onerous duties they take on, as well as the value of their work to the company'. In this respect, the remuneration of audit committee chairmen is likely to require particularly careful consideration. The extra emphasis placed in the new Code on the work of the nomination committee may also mean it is appropriate to review this committee chairman's remuneration – if he or she is not the board chairman. Meanwhile, if a company is setting up a nomination committee for the first time in the light of the Code's recommendations it will also be worth considering the additional time commitment that will be required from the relevant board members.

The Code indicates that non-executive directors should not be paid in share options since to do so might impact their independence. If, however, a company is absolutely intent on granting share options to its non-executives then it should seek shareholder approval prior to going ahead with the plan. Any options should not vest until at least a year after the non-executive director leaves the board. Where an executive director is a non-executive director at another company, the remuneration report should indicate whether they will retain the related earnings and, if so, the amount to which they are entitled.

Figure 3.2

Severance terms - desirable features of arrangements

- ▶ At the outset, boards should calculate the potential cost of termination in monetary terms. When agreeing the terms of the director's contract, boards should resist pressure to concede overly generous severance conditions. They should not support enhanced pension payments without being fully aware of the costs.
- ▶ Objectives set for directors should be clear. This will make it easier to determine whether an executive has failed to perform and therefore to avoid making payments for this element of remuneration in a severance package.
- ▶ Initial contract periods of more than one year may be appropriate in 'highly exceptional circumstances'. The example given is when a chief executive is recruited to a troubled company.
- ▶ Phased payments are welcome. These involve paying the departing executive, say, on a normal monthly basis for the outstanding term of his or her contract. The ABI/NAPF note that shareholders believe this approach has 'considerable advantages' if it is also made clear that the executive has a legal obligation to mitigate their loss as in many cases they will obtain further employment during the course of the payments, limiting future costs.
- ▶ The liquidated damages approach is not generally desirable. The amount that will be paid under this approach in the event of severance is agreed at the outset. Boards wishing to adopt this approach should consider modifying it to require arbitration to decide how much should be paid if severance occurs.
- ▶ Where a director is dismissed as a result of disciplinary action a shorter notice period than set out in the contract should apply.
- ▶ Consideration should be given to provide safeguards in extreme cases, for example if there were a very significant fall in the company's share price relative to the sector.
- ▶ Contracts should not normally provide compensation for severance as a result of change of control.

Source: ABI/NAPF Best Practice on Executive Contracts and Severance, 2003 (abridged)

Disclosure

The disclosure requirements dealing with directors' remuneration are now contained in the statutory based *Directors' Remuneration Report Regulations*⁽³⁾ (see Figure 3.3 for a summary of the main disclosures).

The Remuneration Report Regulations introduced a new requirement for the directors' remuneration report to be approved by a resolution at the AGM. Entitlement to remuneration is not, strictly speaking, conditional on the resolution being passed. Despite this, it would be an unwise board that failed to heed a significant negative vote or abstention by shareholders even if a resolution was passed.

The ABI has welcomed the Remuneration Report Regulations as 'requiring both improved disclosures by companies in their remuneration reports and greater accountability to shareholders'. Its *Principles and Guidelines on Executive Remuneration* make it clear, however, that it expects companies to follow best practice as regards disclosure rather than simply to comply with the regulations. Its primary interest lies in having a full and clear explanation of policy with a clear link established between reward and remuneration. The ABI stresses that companies should undertake a consultation process as they formulate their remuneration policies rather than risk controversy when the resulting schemes are published in the annual report.

Figure 3.3

Key disclosures in the Directors' Remuneration Report

- ▶ Names of remuneration committee members and those who provided advice to it.
- ▶ Statement of remuneration policy for the following and subsequent years.
- ▶ For each director, the policy statement shall include a summary of performance conditions regarding share options/long-term incentive schemes; an explanation of why they were chosen; and a summary of the methods to be used in assessing whether they have been met. The relative importance of elements that are/are not linked to performance are to be explained.
- ▶ A performance graph showing total shareholder return for the company for the last five financial years compared to that of a relevant broad equity market index.
- ▶ Details of directors' service contracts including potential early termination payments.
- ▶ Audited details for each director of their remuneration, interests/movements in share options, interests in long-term incentive schemes, pension details. Payments to past directors.

Source: Department of Trade and Industry, Directors' Remuneration Report Regulations, 2002 (abridged)

Promoting performance

Remuneration committees will find it helpful to carefully track total remuneration and its components over time. This should be done by reference to the return being earned by the company and its shareholders and to the company's performance relative to that of a comparator group. It is the remuneration committee's job when approving incentive schemes to ensure that the linkage between pay and performance is robust. They ought to check that the comparators chosen and the performance criteria set are genuinely challenging and that they are more suitable than possible alternatives. Members of the committee should also assess any 'small print' that may, for example, cover issues such as when the normal criteria may be waived.

The Code's exhortation to provide 'keen incentives to perform at the highest levels' involves building significant levels of leverage into remuneration packages. This does, however, need to be balanced against the risks of aggressive earnings management if those packages are too demanding. Outstanding performance should be very well rewarded but average or modestly above average performance should not unlock high levels of performance-related remuneration.

It is worth remembering that the way directors' remuneration is set is seen by institutional investors and others as an indicator of the board's overall stewardship – as well as being an important issue in its own right.

References

- (1) *Association of British Insurers, Principles and Guidelines on Executive Remuneration, 2003*
- (2) *International Accounting Standards Board, IFRS 2 Share-based Payment, 2004*
- (3) *Department of Trade & Industry, Directors' Remuneration Report Regulations, 2002*

Strategic thinking

- ▶ Does the group have a well-defined strategy? Have various alternative strategies been considered? Are the board and senior management wholeheartedly committed to the strategy?
- ▶ Is the strategy aligned with its distinctive capabilities to provide sustainable competitive advantage? Are the right people in the right roles to implement it?
- ▶ Does the group track its competitive environment on an ongoing basis? Is it in a position to respond to changes in that environment in a timely and effective manner?
- ▶ Are the key performance measures and risks to be managed directly derived from the strategy?
- ▶ Does the board keep the strategy - and its implementation - under regular review?
- ▶ Is the board communicating the strategy successfully to institutional shareholders and other key stakeholders? Are they fully supportive of it?



A strategic approach to gaining a sustainable competitive edge

Writing over a decade ago, Hugh Parker⁽¹⁾ used a yachting analogy to divide the strategic approach of boards into two groups – ‘day sailors’ and ‘ocean-racers’. The former follow whatever course the prevailing winds and tide allow, with the least effort and discomfort for the crew, and return to their moorings in the evening, back where they started. Successful ocean-racing teams, by contrast, have a definite objective and course to follow, recognise that they have a lot of tough competitors and possess a determination to win. They are highly organised and well-motivated with helmsmen, navigators, technicians and other specialists.

If boards are to fulfil their responsibilities under the Code to set the group’s strategic aims they must be ocean-racers and make fundamental policy decisions – not just promote incremental improvements in operating efficiency. They must have a keen understanding of the current and likely future business environment; explore the range of strategic alternatives that are available; and be aware of the likely response of competitors to their chosen path. Above all else, they must be absolutely clear as to the drivers of their success and the threats to their prosperity in the years ahead. The board should also keep a sharp focus on the main objectives that must be fulfilled to keep the business strong and dynamic.

Developing a distinctive strategy

Constantinos Markides points out in *All the Right Moves, A Guide to Crafting Breakthrough Strategy*⁽²⁾ that a strategic position is simply the sum of the company’s answers to the three questions: Whom should I target as customers? What products or services should I offer them? How should I do this? He goes on to emphasise, however, that there are tough choices to be made within each of these three dimensions. It is just as much about the customers, products and services that the business will not target and the activities

it will not pursue as those that it will. He argues that successful companies adopt a distinctive strategy based on a unique combination of the above dimensions so as to differentiate themselves from their competitors. Moreover, a failure to make clear choices in each of the dimensions is a common cause of strategic failure. Markides also stresses that strategy is dynamic. The advantages created by a unique position will eventually be eroded by competitive challenges. This implies that the only way to create enduring success is to perform well in the existing strategic position while continually searching for new positions. Once one has been chosen, the challenge lies in simultaneously managing the old and new approaches.

Markides suggests a company must define its business in order to be able to answer the who, what, how questions outlined above. The definition of the business must enable the company to fully leverage its unique competencies (or strengths). He says, for example, that a leading chain of coffee shops knows it is in the ‘consumption experience’ market and not merely selling coffee. In defining its business sector, a company needs to assess whether it is likely to grow, whether it is protected by barriers to entry and whether it delivers what the company needs in order to be able to succeed. For successful companies, the individual competencies and activities support and reinforce each other. Their power lies in their unique combination in a given business. The most valuable capabilities are those that cannot be imitated or substituted by others without significant expense.

Customer selection is not just about targeting potential new customers within the chosen section of the overall marketplace; it also involves looking at existing customers and asking which should be retained and which no longer fit with the chosen strategy. Likewise, having identified potential new products or services, businesses need to apply a cost-benefit screening mechanism, taking account of their competencies and their customer profiles, to see which will yield the best results. As with all aspects of a business, once products and services have been defined they should be kept under constant review. It is a process that drives continual innovation.

Knowing at what you can be the best in the world

Markides' views on the necessity of a clearly-analysed, well-focused strategy are supported by Jim Collins in *Good to Great*.⁽³⁾ He identified companies within the Fortune 500 list in the United States that had made the transformation from delivering good results to outstanding ones - and then sustained those results for a period of 15 years. Their average stock market return was about seven times that of the market over this period. Collins sought to identify common themes underlying their growth. He concluded that the 'hedgehog concept', drawn from Isaiah Berlin's observation that 'the fox knows many things, but the hedgehog knows one big thing', lay at the heart of their success. The *Good to Great* companies, in contrast to their less successful comparator companies, had a deep understanding of three key dimensions of their business and the interrelationship between them. They were clear what they could be the best in the world at and equally the areas in which they could not achieve such a level of excellence. They understood what drove their economic engine, that is how they could most effectively generate sustained profitability and cash flow. As part of this, they knew which measure of performance was the most important indicator of their success. Thirdly, they were very aware what they were deeply passionate about, in other words the areas to which they were really committed. Collins is clear that the issue is not just about having a good intention or plan to be the best at something but a genuine understanding of the fields in which you can excel.

Capturing the soul of the organisation

Earlier research by Collins with Professor Jerry Porras of Stanford University reported in *Built to Last*⁽⁴⁾ again demonstrates the merits of a focused strategy playing to deep strengths within the business. The distinguishing characteristic of

the companies in this study, all of whom had been successful over a prolonged period, sometimes generations, was that everything was subject to change except for 'a cherished core ideology' comprising the company's core purpose and core values. This core purpose 'captures the soul of the organisation' while the core values represent 'timeless guiding principles that require no external justification'. These might relate to customer service, quality, innovation, market responsiveness or teamwork, depending on the individual company. In summary, the core ideology is 'the bonding glue that holds an organisation together'. See Figure 4.1 for an example of the core ideology of a leading global pharmaceutical company.

Figure 4.1 Example of 'Built to Last' vision for a leading global pharmaceutical company

Core ideology

Core values

- ▶ Corporate social responsibility
- ▶ Unequivocal excellence in all aspects of the company
- ▶ Science-based innovation
- ▶ Honesty and integrity
- ▶ Profit, but profit from work that benefits humanity

Core purpose

To preserve and improve human life.

Envisioned future

To transform the company into one of the pre-eminent drug-making companies in the world, with a research capability that rivals any major university.

Source: Collins, J.C. and Porras J.I., *Built to Last, Successful Habits of Visionary Companies*, Random House 1994

From drawing board to playing field

Boards need to be constantly alert to emerging strategic and market issues that call for strategic changes or 'jumps'. When the board decides that its present strategy will not lead the company in the desired direction in the longer term it will need to embark on a strategic review that may lead to a significant change in course. Implementing that change will require a significant level of leadership and commitment.

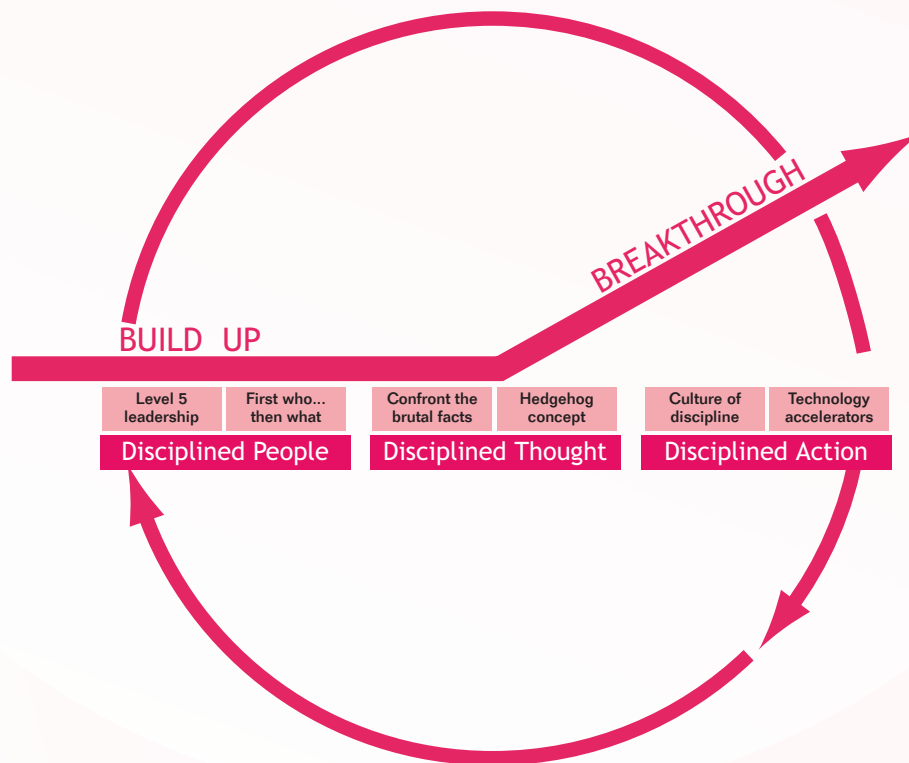
The *Good to Great* companies' leaders were committed to producing sustained high level results and took the difficult decisions to achieve this goal. Their actions were relentlessly consistent with their chosen 'hedgehog concept' (see Figure 4.2) and the combined impact generated great growth momentum. They were ambitious, but principally for the company rather

than themselves, and laid the groundwork for their successors to achieve even more than they did. They first got the right people on the team before addressing issues such as strategy or organisational structure and did not hire people unless they were absolutely sure that they met the team's needs. They acted when they needed to make personnel changes but first checked they did not simply need to move someone into another position to make best use of their strengths. Perhaps most importantly, they put their best people to work on their best opportunities, not their biggest problems.

Overall, the transformation of 'Good to Great' companies was the result of cumulative effort with no single defining moment. Implementation of their strategy came down to persistent, consistent movement in the chosen direction over a sustained period. It was this dedication to the carefully chosen strategic goals that ultimately led to the point of breakthrough.

Figure 4.2

'Good to Great' - The key elements in the transformation



- ▶ Their leaders were a paradoxical mixture of personal humility and professional skills rather than the high profile/celebrity type (Level 5 leadership).
- ▶ 'They first got the right people on the bus, the wrong people off the bus, and the right people in the right seats – and then they figured out where to drive it' (First who --- then what).
- ▶ They maintained unwavering faith that they would ultimately prevail but at the same time had the discipline to confront 'the brutal facts of their current reality' (Confront the brutal facts).
- ▶ Their strategies were founded on a deep understanding of three key dimensions that guided all their decisions (Hedgehog concept).
- ▶ There was a culture of discipline – adherence to a consistent system but with freedom and responsibility within its framework (Culture of discipline).
- ▶ They did not use technology to ignite a transformation but were pioneers in the application of carefully selected technologies (Technology accelerators).

Source: Extracted from Collins, *Good to Great*, 2001 (abridged)

Implementing a successful change programme

In line with the above, Malcolm McKenzie stresses⁽⁵⁾ that if the board decides a strategy and a change/transformation programme is needed, then it must deliver in five areas in order to be effective (see Figure 4.3). He suggests 'the strategy part is fun but not the most difficult part'. He considers it should take boards no more than three months to review, clarify and define the broad strategy and goals for the company. Where it takes significantly longer, he suggests that it is normally an indication that insufficient effort has been invested by the board in getting itself aligned around the key issues. The resulting transformation programme might, on the other hand, last one to two years.

Strong commitment must be secured throughout the organisation to the way ahead with effective management of the desired change. Without it, the effort will be wasted and potential performance improvements will not be realised. It is also essential to recognise that all change programmes will encounter ups and downs - the challenge is to navigate a route through what McKenzie calls the 'valley of despair'. Three key management actions will enable the business to pass through this phase successfully: recognition that the 'valley' exists; continuous communication, feedback and support to help key stakeholders through it; and understanding the importance of 'tipping points'. Tipping points occur when there is broad acceptance of the new strategy, process or way of working as part of everyday life. Achieving this takes real effort but a failure to reach the tipping point will lead to the old, embedded

practices re-emerging triumphant. McKenzie suggests the answer lies in data-based arguments supporting the reason for change coupled with management of the political and emotional dimensions of it. Time needs to be spent consulting around solutions, coaching key influencers and addressing issues or resistance. Many transformation programmes fail because they start too many activities simultaneously and to avoid this problem the change should focus around no more than two or three work streams at any one time.

Quality time

Developing and implementing a strategy best suited to the business will largely determine whether or not the company has a successful future. The board should therefore ensure that it devotes enough time and resources to the task. It must be careful not to let its responsibility to monitor current performance deflect attention from the vital role of giving longer-term strategic leadership to the business. Where strategic change is called for, the role of the board is critical throughout the whole process. It needs to get alignment around the need for change, the strategic choices and the preferred final strategy. With consensus in the boardroom on this, its role is to commit, communicate, lead and mobilise the business as a cohesive team. The recent *Board Effectiveness Survey* of listed companies found that less than half of respondents were confident that their board had developed a strategy that gave their company a competitive edge in line with its capabilities. Many companies still have a long way to travel on their strategic journey.

Figure 4.3

Implementing effective strategy and change programmes

The blueprint for the strategy

What is a simple articulation of how the company is going to compete? What is the business model? How will the various parts of the organisation work together?

The business case

What would happen if there were no change? What is the value that will be created by the new strategy? When, and how, can that be tracked?

The transformation programme

What are the key interventions that are going to be made? When? With what intended effect? How do these workstreams knit together to move the organisation towards its new goal?

A mobilised organisation

The board and cadre of senior management need, by this stage, to be committed and mobilised around the new strategy and transformation programme. There should be a plan as to how this mobilisation will be communicated and rolled out around the organisation.

A 'transformation map'

There should be a joined-up 'transformation map' allowing everyone to view the scope of the activities planned. This is not a timetable as such – rather a summary of the key activities and how they work towards the strategic goal. This enables linkages between the various activities to be more easily identified and accommodated. The transformation map also facilitates deciding which activities have to come first and which can be delayed.

Source: McKenzie, Institution of Mechanical Engineers, 2004

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Managing risk effectively

- ▶ Has the board determined its policies on risk management for the group? Is it clear on its risk appetite?
- ▶ Is the board satisfied that the corporate culture is supportive of the group's approach to risk management?
- ▶ Has the board identified the key risks inherent in the business? Is the nature of those risks regularly reviewed in the light of changes in the internal and external business environment?
- ▶ Does the board regularly receive reports on group risk management and ensure necessary improvements are made to maintain its effectiveness?
- ▶ Is the group able to respond effectively to unexpected crises? Have any arisen that should have been anticipated?
- ▶ Is risk management embedded in the board's decision-making processes? For example, does the board give due consideration to risk when weighing up mergers and acquisitions? Is there a proper recognition of reputation risk?
- ▶ Is the external reporting on risk management concise and insightful?



Managing risk effectively

Profits are the reward for successful risk-taking in a modern competitive economy. Companies that are overly cautious will miss opportunities and are unlikely to succeed in the longer run. Even more certain failure awaits those who take risks recklessly. The board's challenge, therefore, is to ensure risk is managed effectively in the business, not to eliminate it altogether. The board has to be proactive in its oversight role and to recognise that the risks confronting a business are constantly changing.

The board's role

The board's risk management and control responsibilities include:

- ▶ Promoting a culture that emphasises integrity
- ▶ Embedding sound risk management in all aspects of the group's activities
- ▶ Approving the group's 'risk appetite'
- ▶ Determining its principal risks and ensuring that they are communicated to the business
- ▶ Setting the overall policies for risk management and control

- ▶ Adopting the most appropriate scheme of delegation of board responsibilities to committees
- ▶ Receiving reports on a timely and regular basis on the management of key risks and taking appropriate follow-up action. A list of the board's responsibilities with regard to the effectiveness of internal control is set out at Figure 5.1
- ▶ Integrating risk management into the board's own decision-making

The Turnbull Report on risk management and internal control is appended to the Code and provides guidance on the application of the relevant sections of it. It allows the board to delegate tasks to the audit or other board committees but the results of those committees' work should then be reported to, and considered by, the board. The board retains responsibility for internal control disclosures in the annual report. The new Code states that the audit committee should not only consider internal financial controls but should also review the broader internal control and risk management systems unless this has been specifically addressed by a separate risk committee made up of independent directors.

Figure 5.1 Board's role in reviewing the effectiveness of internal control

The board should define the scope and frequency of reports on internal control during the year. The annual assessment process should consider:

- ▶ Key risks and their identification/evaluation/management.
- ▶ The effectiveness of the control system in managing those risks.
- ▶ Whether prompt action has been taken to remedy any significant failings/weaknesses.
- ▶ Any need for more extensive monitoring.
- ▶ Changes between annual assessments in significant risks and the company's ability to respond to changes in the business/external environment.
- ▶ Scope and quality of management's ongoing monitoring of risks and the work of internal audit/other assurance providers.
- ▶ Communication of monitoring results to board.
- ▶ Actual and potential impact of any failings/weaknesses on financial performance/condition.

Source: Extracted from the Turnbull Report, appended to The Combined Code on Corporate Governance, 2003 (abridged)

Focusing on the principal risks

The board should consider all types of risks – whether strategic, operational, compliance or financial. A list of possible risks is set out in Figure 5.2. The board's primary focus should be on the group's principal risks, many of which will be strategic but it should also ensure that financial and other basic controls are working effectively. Companies must identify and manage the risks that threaten the achievement of their objectives – this involves having clear, unambiguous and measurable objectives that emanate from the strategy.

To enable the board to decide which potential risks are most likely to be significant, management should advise it on the likely impact and probability of a range of events and circumstances. The board, with its 'helicopter view' of the business, can have a valuable input into this process but it does need to be complemented by the 'bottom-up' knowledge of those dealing with customers, suppliers and internal processes on a regular basis. Care needs to be taken on two fronts. First, the board must avoid taking too much of a 'top-down' approach to risk – an approach that floats over the organisational structure and is not embedded in it. Secondly, it should resist the danger of a 'bottom-up' approach that misses strategic risks by focusing only on day-to-day operational issues. Combining these approaches will, however, assist the board in identifying the 'gross' risks it faces – that is, risk before any mitigation measures are applied.

Determining the risk appetite

Armed with a list of 'gross' risks, the board can determine, with appropriate delegation to management, how these can be reduced to an acceptable level in line with the group's risk appetite. Risks may be controlled internally (for example, through supervision, division of responsibilities, quality control checks);

transferred through insurance or avoided by declining particular types of business or by way of exclusion clauses in contracts. They can, of course, also be carried as acceptable risks.

The risks remaining after mitigation measures have been applied – the residual risks – are those that the board is willing to bear. The way in which risks are dealt with will depend on the group's 'risk appetite', namely, the amount of risk the board believes it is appropriate for the business to accept. The financial returns to the business, and their volatility around the mean, will vary according to the risk profile and the board needs to be confident that it has the capabilities and resources to cope with the one chosen. It also needs to be conscious of the preferences of shareholders - they will be influenced by whether they are holding the stock for growth or income purposes.

Boards need to be alert to circumstances where management may be tempted to undertake risky business transactions. Equally, they should ensure unnecessary controls are not imposed where the costs outweigh the benefits and which might stifle the spirit of entrepreneurship in the business. Appropriate opportunities to enter new markets, to develop products or services, or to be innovative in their creation or delivery need to be seized. Unnecessary delays or a failure to act can be very costly to the business.

Flexibility of response

The board should be satisfied that responsibility and accountability for managing risk is assigned to individuals at an appropriate level in the business. It should also ensure that there are 'early warning' mechanisms in place to identify problems when remedial action can still be taken. Successfully anticipating risks can prevent crises from occurring, saving valuable time and resources as a result. Companies also increasingly need the speed and flexibility to respond quickly and effectively to circumstances that could not have been foreseen. Contingency and emergency plans should be in place to minimise losses in the event that any crises do occur. These plans should be kept up to date, regularly tested and revised as a result of experience gained.

Figure 5.2
Risks indicator

Strategic

- ▶ Unfocused strategy
- ▶ Strategy not aligned with capabilities
- ▶ Complacency arising from past success
- ▶ Unsuccessful acquisition/abortive bid
- ▶ Failure to manage major change initiative
- ▶ Reputational risk
- ▶ Loss of investors' confidence
- ▶ Political/general economic risk

People

- ▶ Leadership/management not able to drive company forward
- ▶ Inadequate succession planning
- ▶ Loss of key players
- ▶ Poor employee motivation
- ▶ Internal communication weaknesses

Marketplace

- ▶ Not responding to market trends/failure to innovate
- ▶ Missed opportunities – internet developments, global markets
- ▶ Weak brands
- ▶ Over-reliance on a few customers
- ▶ Poor level of customer satisfaction – quality/timeliness

Ethical

- ▶ Failure to enact high standards of ethics across business
- ▶ Obtaining contracts unethically
- ▶ Stakeholder concerns on products/business probity

Suppliers/outsourcers/ strategic alliances

- ▶ Over-dependence on suppliers/outsourcers
- ▶ Failure to manage cost/quality of outsourced service suppliers
- ▶ Supply chain problems – human rights, child labour
- ▶ Joint ventures, strategic alliances not working

Financial

- ▶ Cash flow/going concern problems
- ▶ Treasury operations risk
- ▶ Susceptibility to fraud/accounting irregularities

Legal/compliance

- ▶ Failure to protect intellectual property
- ▶ Health, safety, environmental issues
- ▶ Litigation risk
- ▶ Breach of competition, corporate, employee or taxation laws

Source: RSMi International, *Building World-Class Boards*, 2003⁴⁴

Embedding risk management

The board should ensure that risk management is fully embedded in the organisation's culture and processes. Companies should have a code of ethics and be seen to uphold it when difficult choices have to be made. A code that is out of line with management behaviour, decisions and the way that incentives are granted in practice can be very corrosive so its application in practice must be kept under regular review. Arrangements should be put in place to encourage those with concerns about ethical breaches or other irregularities to come forward – if need be, independently of line management. Formal self-assessment processes can also have a significant role to play in successful risk management. They could, for instance, involve staff in key positions being asked to give a signed statement to the board concerning compliance with the company's ethical code and policies or confirming the

reliability of accounting and reporting procedures. Risk management issues should also feature in the objective setting, appraisals and resulting remuneration of employees.

Communications and training across the group at all levels are essential to highlight everyone's risk management responsibilities. They can help develop a culture of continuous improvement with lessons being learned from any failures or weaknesses identified in the system. Companies should also learn from their competitors' problems or 'near misses', introducing new risk management systems or processes accordingly. That said, a balance needs to be struck between making sure experience informs future action and dealing with something that has already been and gone. The primary focus must be on addressing today's and tomorrow's threats to the achievement of objectives. Some pitfalls to avoid in risk management are listed in Figure 5.3.

Figure 5.3

Risk management pitfalls

- ▶ **Box-ticking rather than business-led approach.**
- ▶ **Failure to prioritise key risks.**
- ▶ **Too narrow a focus on financial risks.**
- ▶ **Not enough attention paid to changes in the internal or external environment.**
- ▶ **Board discussing risk but not integrating it into their own decision-making.**
- ▶ **Failure to embed risk management in organisational culture and processes.**

Source: RSMi International, Building World-Class Boards, 2003⁴⁰

In the boardroom

The board has a responsibility to set a good example on risk management by carefully addressing risks in its own decision-making. Many of those decisions, by their very nature, will have a crucial impact on the company's future. Despite this, only just over a third of respondents (36%) to the *Board Effectiveness Survey* fully agreed that their boards ensure risk analyses are submitted to them prior to the approval of key initiatives.

Board-level discussion of risks will be essential, for example, in dealing with acquisitions. Companies with an experienced project manager working on acquisitions from identification until post-implementation evaluation are 71% more likely to have successful acquisitions than those who do not. ⁽¹⁾ Issues to be addressed might include:

- ▶ Is there a strong business case for the acquisition? Has the target been carefully identified in line with the strategy rather than being forced to fit it?
- ▶ What risks might jeopardise achievement of the planned synergies?
- ▶ Are the political, regulatory and environmental risks understood?
- ▶ How will competitors react to the bid?
- ▶ Where it is desired for target management to be 'locked in', what mechanisms are in place to secure their motivation?

Capital structure risk also requires board attention. Once again, only 41% of *Board Effectiveness Survey* respondents were fully satisfied that their board has the necessary financial and human capital resources available to implement its chosen strategy. Prudent preventative measures in this area are likely to include: ⁽²⁾

- ▶ the avoidance of excessive, short-term, confidence-sensitive debt;
- ▶ staggering debt maturities;
- ▶ maintaining cordial relations and credibility with banks during bad times and good;
- ▶ negotiating 'loose' bank loan covenants while the company is financially strong;
- ▶ maintaining bank lines in excess of anticipated needs;
- ▶ negotiating renewals well in advance of expiration;
- ▶ fully drawing credit lines at the onset of major difficulties.

Reputation risk must also be high on the board's agenda. Many leading businesses have enhanced internal controls, reviewed auditor/accounting relationships, revised codes of conduct and provided ethics-related employee training in response to the much publicised corporate scandals of recent years. The risks of unethical behaviour remain at the forefront of CEOs' minds when asked to identify the main threats to reputation. They rate alongside product/service problems, customer criticism, media criticism, a disaster disrupting operations and litigation or adverse court judgements. ⁽³⁾

Managing risks, taking opportunities

A wholehearted commitment to effective risk management will help create a forward-looking entrepreneurial business that is fully conscious of its external and internal environment – and of the constant changes in them. Such businesses will always be striving to set priorities, develop and improve.

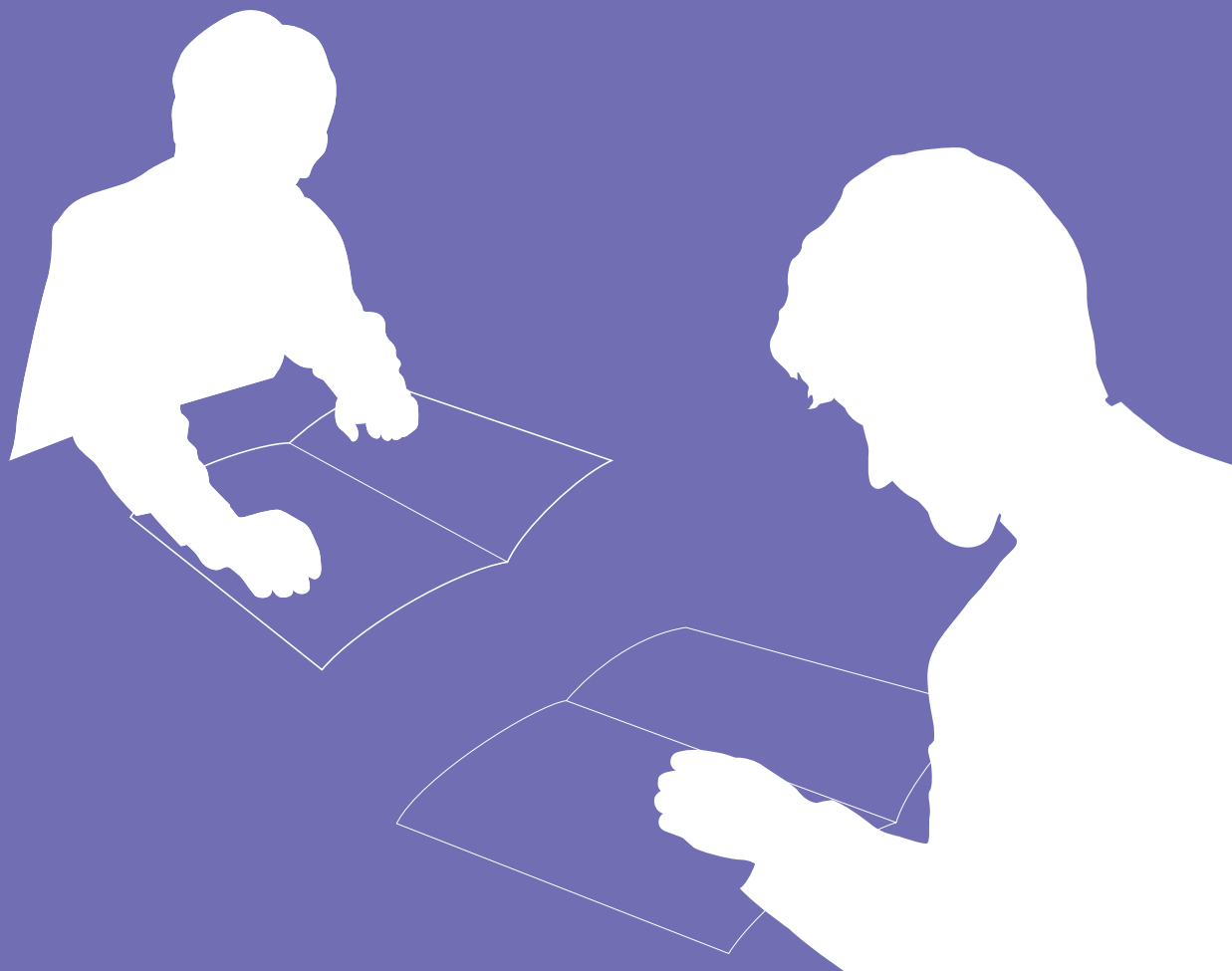


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- (2) *International Federation of Accountants, Managing Risk to Enhance Stakeholder Value (R. Darke, Capital Structure Risk and Bond-Rating Agencies), 2002*
- (3) *Corporate Reputation Watch, Korn/Ferry International and Hill & Knowlton, 2003*
- (4) *RSMi International, Building World Class Boards, 2003*

A robust audit committee

- ▶ Does the audit committee possess the necessary financial, business and governance expertise? Does it have enough meeting time to fulfil its remit effectively?
- ▶ Are all significant financial pronouncements thoroughly reviewed by the committee before they are publicly released? How is the company's quality of reporting regarded externally?
- ▶ Does the committee lead in the company's relationship with the external auditors? Does it actively monitor audit effectiveness and the auditors' independence?
- ▶ Are the company's internal financial controls and, where applicable, the overall internal control and risk management systems subject to rigorous ongoing review by the committee? Is any follow-up action monitored?
- ▶ Does the internal audit function make a substantial contribution to risk management in the business?
- ▶ Are the 'whistleblowing' arrangements to enable staff to raise concerns about possible improprieties working well?
- ▶ Are the annual report disclosures on the audit committee's work concise and insightful?



A robust audit committee

'While all directors have a duty to act in the interests of the company the audit committee has a particular role, acting independently from the executive, to ensure the interests of shareholders are properly protected in relation to financial reporting and internal control.'

The Smith Report, appended to the Code, thus defines the role of the audit committee and provides guidance as to the application of the Code in these areas. Whilst this definition places a heavy burden of responsibility upon the members of the audit committee, the Smith Report goes on to point out that all directors still hold an equal legal responsibility for the company's affairs. As a committee of the board, any disagreements between it and the rest of the board should be resolved at board level. Where an issue cannot be resolved, the audit committee should have the right to include it in its report within the wider annual report.

The Smith guidance stresses that management is under an obligation to ensure that the audit committee is kept properly informed and should take the initiative in supplying information rather than waiting to be asked. The core functions of the committee relate to 'oversight', 'assessment' and 'review' of the functions carried out by management and the internal and external auditors. The high-level overview role may, however, result in the need for members of the committee to undertake detailed work. The Smith Report stresses that the audit committee must intervene if there are signs that something may be seriously amiss. Companies need to make the necessary resources available to audit committees to enable them to undertake their 'wide-ranging, time consuming and sometimes intensive work'.

The Code indicates that the main role and responsibilities of the audit committee should be set out in written terms of reference and should include the items shown in Figure 6.1. The overall role of the audit committee has not been changed significantly in the new Code. Despite this, the much more detailed discussion in the Smith

Report as to how audit committees should discharge their responsibilities is likely to lead to many of them spending more time in fulfilling their remit. It may also require the companies to allocate more resources to assist them in their work.

Committee composition

All members of the audit committee should be independent non-executive directors. For FTSE 350 companies, there should be a minimum of three members and for other listed companies at least two members. The new Code adds that the board should satisfy itself that at least one member of the committee has recent and relevant financial experience. This requirement is likely to lead to a number of boards reviewing their audit committee membership. In practice, it will be generally helpful if the audit committee chairman has strong financial skills but it is also important that the committee members have good knowledge of the business and its sector. In addition, they should have appropriate personal characteristics such as the ability to ask challenging questions and to arrive at balanced judgements in complex situations.

The results of the committee's work should be considered by the board as a whole. Reports should include an indication of areas where action or improvement is needed and recommendations on how matters should be followed up.

Meetings of the committee

The Smith guidance recommends that there should be as many meetings as the audit committee's role and responsibilities require. It suggests at least three meetings a year, for example, when the internal and external audit plans are ready for review and when interim statements, the preliminary announcement and the full annual report are near completion. It should be stressed that three meetings is only a minimum recommendation – most audit committee chairmen will wish to call more meetings. The pressures on audit committees have undoubtedly

Figure 6.1

The audit committee's main responsibilities

- ▶ To monitor the integrity of the financial statements and any formal announcements on the company's financial performance.
- ▶ To review the company's internal financial controls and (unless done so by the board/separate risk committee) its internal control and risk management systems.
- ▶ To monitor/review the effectiveness of the internal audit function. If one does not exist, the committee should annually consider the need for establishing one, make a recommendation to the board and explain the reasons for its continued absence in the annual report.
- ▶ To make recommendations to the board on the appointment/removal of the external auditor and to approve their terms of engagement and remuneration. If the board does not accept the audit committee's recommendation, the committee should explain its recommendation in the annual report and the board should set out its reasons for taking a different position.
- ▶ To monitor/review the external auditor's independence/objectivity and the effectiveness of the audit process. If non-audit services are provided then the annual report should explain how objectivity and independence are safeguarded.
- ▶ To develop/implement policy on the engagement of the external auditor to supply non-audit services and to report to the board on actions/improvements needed in this area.
- ▶ To review arrangements by which staff may raise concerns about possible improprieties ('whistleblowing') in order to ensure arrangements are in place for their proportionate/independent investigation and for follow-up action.

Source: *The Combined Code on Corporate Governance, 2003 (abridged)*

increased so looking forward it would be wise for boards to ensure their audit committee members have enough time at meetings to properly discuss their areas of responsibility. It would not be a good idea to unduly condense the time allocated to items in order to fit them in to the limited amount of time that has traditionally been available when a more appropriate solution would be to increase the number of meetings held.

Training and updates

In view of the pace of regulatory developments it is important to establish a development programme for audit committee members. The Smith guidance suggests training should be provided on an ongoing basis and should include an understanding of the principles of, and

developments in, financial reporting and related company law. However, it will be helpful for the programme to go beyond regulatory and standard-setting issues to enable the committee to understand the environment in which the business is operating. Such training might cover emerging trends, developments in best practice, the results of relevant surveys and new supportive guidance that will assist the committee in fulfilling its remit. For the next few years at least, many companies may be applying International Financial Reporting Standards in their consolidated accounts and UK GAAP in other accounts. Audit committee members will need to be kept up-to-date on both sets of standards. Similarly, for those with US listings, it will be necessary to keep abreast of developments in accounting and regulatory issues on the other side of the Atlantic.

Audit planning

The audit committee must ensure appropriate plans are in place for the audit at the start of each audit cycle. It should review the scope of the audit; the planned levels of materiality; the seniority, expertise and experience of the audit team; and the amount of time the auditors plan to spend on the audit. The committee should also agree the engagement letter with the auditor and be satisfied that an effective audit can be conducted for the proposed fee.

Review of audit findings

In reviewing findings from the audit, the Smith Report recommends that the audit committee should:

- discuss with the external auditor major issues that arose during the course of the audit. This should include issues that have subsequently been resolved and those that have been left unresolved;
- review key accounting and audit judgements;
- review levels of errors identified during the audit, obtaining explanations from management and, where necessary the external auditors, as to why certain errors might remain unadjusted;
- review the audit representation letters before signature by management, giving particular consideration where representation has been requested on non-standard issues; and
- review the management letter from the auditors and management's responses to their findings and recommendations.

Figure 6.2

Quality of financial reporting - areas of potential concern

- **Complex business/financing structures without obvious commercial rationale.**
- **Transactions/adjustments around the year-end having significant impact on the financial statements.**
- **Results that are difficult to explain from an understanding of the underlying business.**
- **Evidence of disagreements with auditors and/or management dominance of the audit team. Auditors experiencing difficulty/delays in obtaining sufficient audit evidence. Many misstatements found during audit.**
- **Doubts on quality of reporting expressed by analysts, rating agencies or financial media.**
- **Accounting policies/practices different from the industry norm, especially if there is a cumulative bias in the direction of management.**
- **Unusual trends in financial ratios – for example, cash flows not in line with expectations given turnover/profits, build-up of debtors/work in progress.**

(Issues to consider based on current good practice)

Financial reporting

Management should inform the audit committee of the methods used to account for significant or unusual transactions where the accounting treatment is open to different approaches. When reviewing the company's annual financial statements, the audit committee should then:

- ▶ take account of the external auditor's view and consider whether the company has adopted appropriate accounting policies and made appropriate estimates and judgements;
- ▶ review the clarity and completeness of disclosures and consider whether they are properly set in context;
- ▶ review the Operating and Financial Review, the Directors' Remuneration Report, corporate governance and risk management statements and other information presented with the financial report; and
- ▶ report any concerns to the board.

As part of its review, the audit committee should stand back and make a judgement on the overall quality of the information being published. A list of some of the issues that might trigger concern is set out in Figure 6.2.

Evaluation of the auditor

The Institute of Chartered Accountants in England & Wales⁽¹⁾ has suggested a range of questions that the audit committee may wish to ask in evaluating the effectiveness of the audit process (see Figure 6.3). It suggests that the 'overarching' issue will be the quality of leadership in the engagement team as this will set the tone for the audit. One area that the audit committee might want to address is the quality of the audit partner's leadership in implementing the agreed audit strategy. The auditors should also be able to show that they are thinking about key issues and that they can interact effectively with the management team while challenging them, if required, on contentious issues.

Figure 6.3 Evaluating the audit process

- ▶ Did the audit partners and senior audit staff have an up-to-date understanding of the business?
- ▶ How effectively did the audit work focus on major issues and did it deal appropriately with them?
- ▶ What recommendations were made for improvements to internal controls and other areas? Were they useful?
- ▶ Did the auditors make appropriate use of experts and technology in their audit work?
- ▶ What was the quality of comments and reports on the non-statutory items? For example, did the audit team report on the board's corporate governance statement?
- ▶ Was the work of internal audit used appropriately?
- ▶ Were formal audit documents, for example, the audit plan and management letters, of sufficient quality?
- ▶ Were the right numbers and quality of partners and staff used on the audit?

Source: Extracted from The Institute of Chartered Accountants in England & Wales, Evaluating your auditors, 2003 (abridged)

Independence and non-audit services

It is the audit committee's job to monitor the independence and objectivity of the auditor. It should seek information on an annual basis from the audit firm on policies and processes for maintaining independence and on how it monitors compliance with the relevant requirements.

The committee should develop a formal policy for the provision of non-audit services by the auditor. It should specify the types of work from which the external auditors are excluded, those for which they can be engaged without referral to the committee and those for which a case by case decision is necessary. The audit committee should also check that there are safeguards in place to ensure that there is no threat to audit objectivity and independence as a result of the provision of non-audit services. These checks will require a regular review of the nature of such services along with a comparison of the fees relative to the audit fee – for individual assignments and in aggregate.

Effectiveness of internal audit

An effective internal audit function can help provide assurance that there are appropriate corporate governance processes in place. It may be provided by employees of the company, outsourced or a mixture of both. A good internal audit function can also reassure investors and other stakeholders that:

- ▶ there is a robust risk management culture with all significant risks managed to the level agreed by the board;
- ▶ effective controls exist over all business operations to prevent undesired exposure to threats and to exploit opportunities; and that
- ▶ actions are underway to remedy any control deficiencies.

The Smith Report recommends that when reviewing internal audit the audit committee should:

- ▶ ensure that the head of internal audit has direct access to the board chairman and the audit committee, and is accountable to the committee;
- ▶ review and assess the annual internal audit work plan;
- ▶ receive a report on the results of the internal auditors' work on a periodic basis;
- ▶ review and monitor management's responsiveness to the internal auditor's findings and recommendations;
- ▶ meet with the head of internal audit at least once a year without management present; and
- ▶ monitor and assess the role and effectiveness of the internal audit function in the overall context of the company's risk management system.

To help audit committees appraise their internal audit function, the Institute of Internal Auditors – UK and Ireland has developed 30 questions as a starting point for the exercise. ⁽²⁾ Some of those questions are shown in Figure 6.4.

Whistleblowing

The Institute of Chartered Accountants in England & Wales has pointed out ⁽³⁾ that the audit committee should have a 'high level' role in relation to whistleblowing. As such, the committee is not responsible for any whistleblowing arrangements or their operation although follow-up action may be needed if there are signs that they are inadequate or ineffective. However, it suggests that the audit committee may wish to allow staff with concerns to contact its chairman directly. This open-door policy can be viewed 'as an effective method of demonstrating the board's commitment to the success of the process and its independence'.

Figure 6.4

Assessing the effectiveness of internal audit - some key questions

- ▶ Does the internal audit function have the appropriate technical expertise, qualifications and experience to provide assistance in all areas of the business?
- ▶ Has it given due consideration to the monetary/operational cost of control and assurance? Have these been balanced against the benefits?
- ▶ Have there been any significant control breakdowns or surprises in areas that have been reviewed by internal audit?
- ▶ Is the internal audit function benchmarked against industry best practice?
- ▶ Is it focused on key issues that concern the board?
- ▶ Can it respond quickly to changes within the organisation?
- ▶ Does the internal audit function ask powerful questions that stimulate debate and lead to improvements in key risk areas?
- ▶ Does management feel that recommendations made by internal audit are useful, realistic, forward-looking and meet their needs?

Source: Extracted from The Institute of Internal Auditors – UK and Ireland, Appraising internal audit, 2003 (abridged)

The Institute's guidance on whistleblowing includes a range of questions that audit committees might ask. For example, are there issues or incidents the board has learned of which they would have expected to have been raised at an earlier stage? Has the internal audit function performed any work on the effectiveness of the whistleblowing procedures? Are there adequate procedures to track the actions taken in relation to concerns raised? Do those procedures ensure appropriate follow-up action has been taken?

An open working relationship

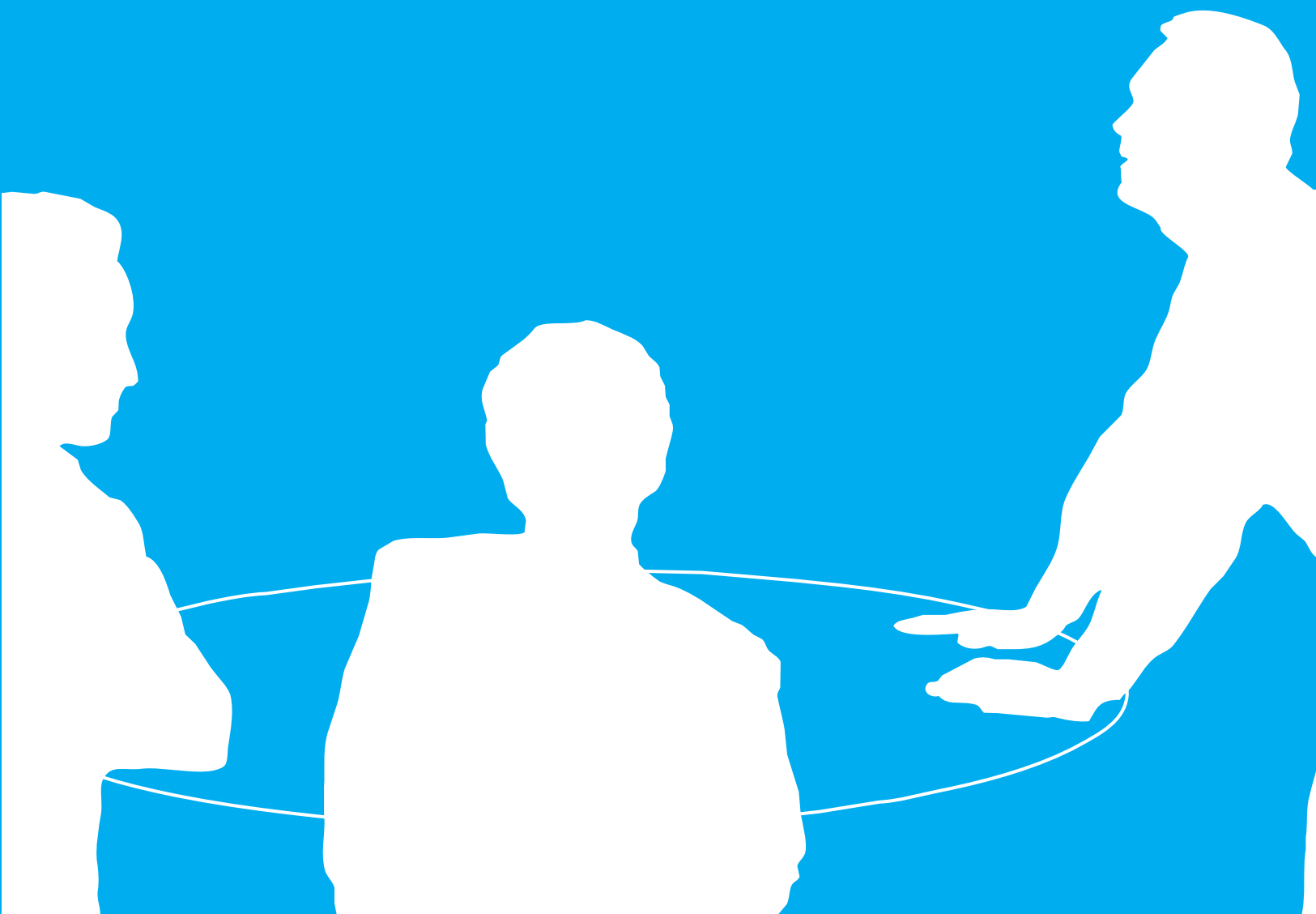
As the Smith Report highlights the most important features of the audit committee's relationship with executive management and the internal and external auditors cannot be drafted as guidance or put into a code of practice. It stresses that it is about 'a frank, open working relationship and a high level of mutual respect'. It goes on to note that 'the audit committee must be prepared to take a robust stand, and all parties must be prepared to make information freely available to the audit committee, to listen to their views and to talk through the issues openly'.

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Taking corporate social responsibility on board

- ▶ Does the board's approach to corporate social responsibility flow directly from the corporate strategy?
- ▶ Is there a board member with a special remit for corporate social responsibility issues?
- ▶ Have key stakeholders been involved in determining the group's corporate social responsibility focus? What are their views on the group's approach and performance in this area?
- ▶ Are relevant external guidelines being followed?
- ▶ Have demanding targets and deadlines for action been set in key areas?
- ▶ Have the principal risks and opportunities related to corporate social responsibility been identified?
- ▶ Is there transparency in reporting progress made and in discussing the scope for further development?



Taking corporate social responsibility on board

Listed companies are increasingly recognising that their social and environmental performance can help create long-term value for shareholders and other stakeholders. They have also begun to recognise that a failure to monitor and develop performance in these areas can destroy value in the business.

A recent World Economic Forum survey of business leaders⁽¹⁾ concluded that there is a growing consensus of the key business reasons for supporting corporate social responsibility best practice. These include:

- ▶ protecting and enhancing reputation, brand equity and trust;
- ▶ attracting, motivating and retaining talent;
- ▶ managing and mitigating risk;
- ▶ improving operational and cost efficiency;
- ▶ giving the business a licence to operate;
- ▶ developing new business opportunities – new products and services, new markets, new alliances, new business models; and
- ▶ creating a more secure and prosperous operating environment.

Figure 7.1 illustrates the main sources of pressure on business to adopt high standards of corporate behaviour. Successful businesses create a virtuous circle around their investors, employees, customers, suppliers and the communities in which they operate. Stakeholders will

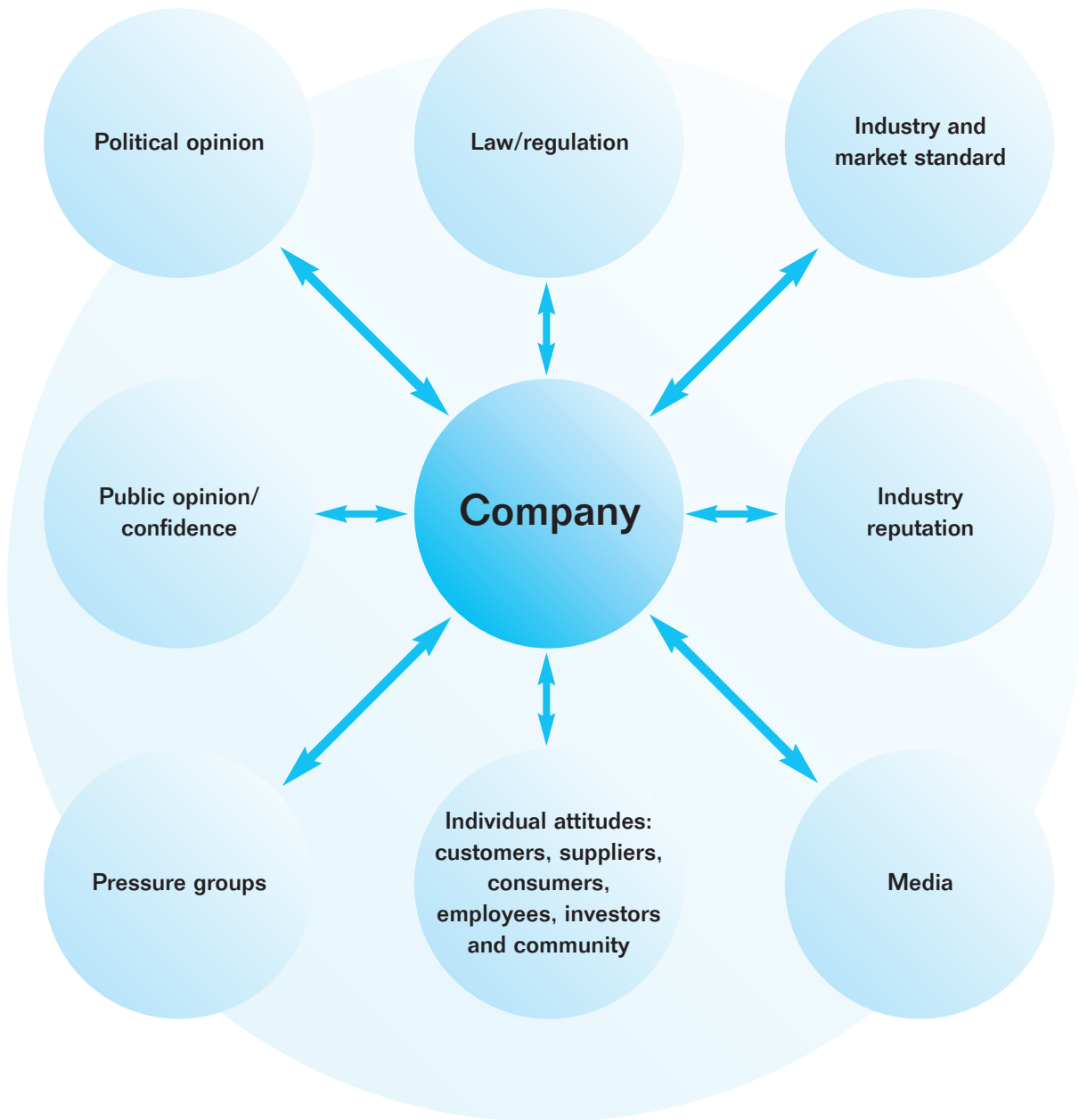
demonstrate a stronger level of commitment to companies that address their needs and expectations. Conversely, those who focus purely on short-term financial results, ignoring the problems that their businesses are causing to others, risk becoming caught in a vicious downward spiral. The result could be a declining reputation that leads to difficulties in attracting customers or good employees and eventually translates into a poor stock market rating.

Boardroom leadership

To be effective, a commitment to corporate social responsibility must have the wholehearted support of the board. It has to be a long-term commitment that involves ongoing improvement in measurement, verification, performance and reporting. Once decided, the company's position should be reflected in its statement of values or purpose and its core principles of doing business.

The board must also ensure that it devotes enough time to corporate social responsibility issues and that they are taken into account as a matter of course when, for example, making acquisitions or other major investments. It may be worth appointing an executive director with a special brief for corporate social responsibility issues across the business. Alternatively, when selecting independent directors there could be merit in appointing somebody with corporate social responsibility expertise and giving them a designated board leadership role in this area. A few boards have appointed a separate committee as a focal point for their work on corporate social responsibility.

Figure 7.1
Sources of pressure on business



Source: Centre for Tomorrow's Company, included in Nelson, J. et al, *The Power to Change*, The Prince of Wales International Business Leaders Forum and Sustainability, 2001 ⁽⁵⁾

A company-specific focus

To have credibility, the group's corporate social responsibility policy and action plan must tackle the significant issues confronting the company. They should be treated as mainstream business issues.

A report commissioned by the Association of British Insurers (ABI)⁽²⁾ has identified three recent general trends in corporate social responsibility that will help businesses formulate their approach. Firstly, corporate social responsibility is now widely accepted. It has spread throughout the business world and is no longer seen as just affecting those sectors where traditionally there have been high profile issues such as oil, chemicals or branded merchandise businesses sourcing their goods from the developing world. Secondly, corporate social responsibility has started to move from the periphery of business to its core, where it is being integrated into business strategy and marketing. Thirdly, there is an increasingly sharp focus on company and sector-specific issues. The ABI report concludes that while all companies face generic risks, it is the specific ones that may present the greater risk or

opportunity in many instances. Many of the generic risks are covered in key codes, for example the UN Global Compact and the OECD Guidelines for Multinationals (see Figure 7.2). Examples of sector-specific risks are:

Social exclusion

A major issue for the financial sector in providing banking and insurance services to those on low incomes. It also tends to affect utilities and pharmaceutical groups, the latter as regards access to drugs in the developing world.

Excessive consumption

A failure to discourage customers from consuming too much of their products or services. Alcohol, tobacco and gambling have long been in this category but it has recently been extended to 'unhealthy' – or too much – food and the provision of credit cards.

Fair trade

Traditionally focused on offering a fair price to suppliers of commodities in the developing world, for example tea and coffee. It has now been extended to include relations between, say, UK farmers and major food retailers.

Figure 7.2

Main issues covered by international codes

- ▶ Treatment of employees/workers in the supply chain - embracing diversity, health and safety, pay and conditions, child labour.
- ▶ Human rights issues - for example torture, political imprisonment, bribery and corruption.
- ▶ Environmental impacts - including sourcing of materials, product use and disposal.
- ▶ Community impacts - including support for community organisations and the economic impacts of location decisions.
- ▶ Transparency - engagement in dialogue and reporting of performance in the above areas.

Source: ABI, Risk, Returns and Responsibility, 2004

Engaging with key stakeholders

Companies should engage with their key stakeholders to determine what they regard as the group's principal corporate social responsibility challenges and to understand if they are addressing them. This feedback can then help develop the group's corporate social responsibility agenda – a process that should be led by board members or senior management. Much remains to be done on engagement with stakeholders: less than one in seven of respondents (14%) to the *Board Effectiveness Survey* fully agreed that their board monitors how key stakeholders view their company's corporate social responsibility performance. This was the least positive response, by a wide margin, to any question in the survey. Existing meetings with stakeholder groups – for example, the financial community and employees – can be used to ascertain their views on corporate social responsibility issues. It may also be worth establishing whether those stakeholders with whom the business regularly meets have specific corporate social responsibility representatives. For example, many fund management groups will now have somebody who is permanently focused on these issues. New arrangements should also be made to meet with stakeholder groups that do not have a regular audience with the company. There might be 'one off' meetings or more permanent advisory panels. A merit of cross-stakeholder discussions is that both they and the business can see the 'trade-offs' that will be required in responding to their differing needs. Annual meetings and the corporate website are also useful channels through which to provide information and encourage two-way dialogue on corporate social responsibility issues.

Guidelines

While the Code does not directly refer to corporate social responsibility, it falls squarely within the principle that 'the board should state the company's values and standards and ensure that its obligations to its shareholders and others are met'. Corporate social responsibility will impinge on the application of much of the Code,

including risk management, dialogue with institutional shareholders and reporting.

The UK Government is committed to introducing an expanded mandatory Operating and Financial Review (OFR) in the annual report of quoted UK companies in the near future. It will require forward-looking discussion of broader strategic issues. The draft regulations make specific reference to including relevant information on employees, environmental matters and social and community issues. The existing OFR, revised by the Accounting Standards Board in 2003, already calls on companies to discuss the objectives of the business which may include those in the area of corporate responsibility.

The ABI's best practice guidelines⁽³⁾ outline disclosures that institutional investors would look for in the annual reports of listed companies (see Figure 7.3). Their recent report showed that while 80 of the top 100 companies have provided full or moderate disclosure on social, environmental and ethical issues (23% and 57% respectively) less than half of other listed companies have achieved a similar level. For FTSE 250 companies the comparative figures are 2% full and 46% moderate disclosure, while for the FTSE All Share companies only 6% provide full and 35% moderate disclosure. Full disclosure means compliance with the ABI guidelines on social, environmental and ethical issues. This includes defining board and management responsibility in these areas; identifying the relevant risks, their business impact and policies and procedures to deal with them; disclosing performance and targets for quantifiable risks; and some form of internal or external verification or audit.

Another set of respected guidelines has been developed by the Global Reporting Initiative (GRI). Over 600 companies around the world have produced hard-copy corporate social responsibility reports in each of the last two years and about half of them refer to the GRI guidelines. A summary of those guidelines on report content is shown in Figure 7.4.

The UK's Business in the Community (BITC) has also developed a set of indicators, many of which are similar to the GRI guidelines. BITC's *Corporate Responsibility Index*⁽⁴⁾ rates companies according to their own assessment of their corporate responsibility processes and

Figure 7.3

ABI disclosure guidelines on socially responsible investment

Board disclosures

The company should state in its annual report whether the board:

- ▶ Takes regular account of the significance of social, environment and ethical (SEE) matters to the business of the company.
- ▶ Has identified and assessed the significant risks to the company's short and long-term value arising from SEE matters, as well as the opportunities to enhance value that may arise from an appropriate response.
- ▶ Has received adequate information to make this assessment and that account is taken of SEE matters in the training of directors.
- ▶ Has ensured that the company has effective systems in place for managing significant risks. Where relevant, these should incorporate performance management systems and appropriate remuneration incentives.

Policies, procedures and verification

The annual report should:

- ▶ Include information on SEE-related risks and opportunities that may significantly affect the company's short and long term value and how they might impact on the business.
- ▶ Describe the company's policies and procedures for managing risks to short and long-term value arising from SEE matters.
- ▶ Include information about the extent to which the company has complied with its policies and procedures for managing SEE risks.
- ▶ Describe the procedures for verification of SEE disclosures. They should be such as to achieve a reasonable level of credibility.

Source: ABI, *Disclosure Guidelines on Socially Responsible Investment, 2001 (abridged)*

performance. The *Corporate Responsibility Index* has been designed to promote a systematic approach to measuring, managing, and reporting the various impacts that companies have upon society and their environment. The latest results from over 130 participating companies⁽⁴⁾ suggest that the majority are looking at corporate responsibility issues across their businesses. However, the integration of responsible business practice across operations is less advanced than

the development of corporate strategy in this area. Likewise, corporate social responsibility is being considered as part of the risk evaluation process but further engagement of external stakeholders is required. Four out of five of the participating companies have a board director with explicit responsibility for human rights but many need to focus on educating and training their staff to ensure their codes of business behaviour are being implemented in practice.

Figure 7.4

GRI reporting guidelines: suggested content of sustainability report

Vision and strategy – description of the reporting organisation's strategy with regard to sustainability, including a statement from the CEO.

Profile – overview of the reporting organisation's structure and operations. Also to include the scope of the report.

Governance structure and management systems – description of organisational structure, policies and management systems, including stakeholder engagement efforts.

GRI content index – a table supplied by the reporting organisation identifying where the information listed in Part C of the Guidelines is located within the organisation's report. Part C covers direct economic, environmental and social impacts (labour practices, human rights, society and product liability).

Performance indicators – measure of the impact or effect of the reporting organisation divided into integrated economic, environmental and social performance indicators.

Source: Global Reporting Initiative, GRI Reporting Guidelines, 2002⁶⁰

A balancing act

The World Economic Forum report referred to at the beginning of this chapter points out that balancing long-term goals with short-term imperatives and managing and accounting for a plethora of non-traditional risks and opportunities

calls for new leadership skills and new approaches to communication. It also calls for new types of co-operation. Investors and corporations can do much to work together in a manner that makes sound business sense while also increasing our common ability to manage risk and promote sustainable prosperity.

References

- (1) World Economic Forum, *Values and Value, Findings of a 2003 CEO Survey of the World Economic Forum Global Corporate Citizenship Initiative in partnership with The Prince of Wales International Business Leaders Forum, 2004*
- (2) Association of British Insurers, *Risks, Returns and Responsibility, 2004*
- (3) Association of British Insurers, *Disclosure Guidelines on Socially Responsible Investment, 2001*
- (4) Business in the Community, *Corporate Responsibility Index, 2003* (bitc.org.uk/docs/2nd_Corporate_Responsibility_Index_Executive_Summary.pdf)
- (5) Nelson J. et al, *The Power to Change: Mobilising board leadership to deliver sustainable value to markets and society, The Prince of Wales International Business Leaders Forum and Sustainability, 2001*
- (6) Global Reporting Initiative, *GRI Reporting Guidelines, 2002*

An active dialogue with shareholders

- ▶ How effective is the company's investor relations programme in developing two-way dialogue with institutional investors, private investors and analysts? How could it be enhanced?
- ▶ Is the board fully aware of institutional investors' views of the strategy and performance of the group and of the quality of its management/board?
- ▶ Does the company thoroughly evaluate its investor relations performance?
- ▶ Have new investors been identified and targeted for meetings?
- ▶ Are there procedures in place to manage relationships with shareholders in the event of a crisis?
- ▶ How satisfactory is the amount and content of company coverage in the financial media? What improvements could be made in this area?
- ▶ Do the annual report/AGM/website meet the needs of users and accord with best practice?



An active dialogue with shareholders

Less than half the respondents to the *Board Effectiveness Survey* – just 47% – said that their board has a complete understanding of investors' expectations of the company and how they perceive its performance. It is therefore timely that the new Code has enhanced coverage on maintaining an effective two-way dialogue with institutional shareholders. Indeed, it is particularly apt given the growing willingness of institutional investors to express concern actively when they feel the situation demands it.

Dialogue with institutional shareholders

Institutional shareholders include insurance companies, life assurance companies, pension funds, investment trusts and other investment management groups. As a group, they are significant shareholders in many listed companies including all larger ones. In some smaller listed companies, a handful of institutions sometimes hold a very significant proportion of the shares. Where hedge funds have an interest in a company's shares this may introduce an element of volatility through the buying and selling of large tranches of shares in a relatively short period.

The Code stresses that there should be a dialogue with shareholders based on a mutual understanding of objectives. The board as a whole is given the responsibility for ensuring that the dialogue is satisfactory. The Code acknowledges that most shareholder contact will be with the CEO and finance director but says that the chairman should maintain sufficient contact to understand issues and concerns. He or she should also be in a position to discuss governance and strategy matters with investors and feed their views back to the board. In addition, the senior independent director should attend sufficient meetings so that he or she, like the chairman, can develop a balanced understanding of the issues and concerns of the major shareholders. Non-executive directors

should be offered the opportunity to attend meetings with major shareholders and are expected to do so if shareholders request a meeting.

Added together, these provisions make it much more difficult for any institutional shareholder concerns not to be known by the chairman and independent directors. The Code also states that the annual report should set out the steps taken to ensure the board and, in particular the non-executive directors, develop an understanding of major shareholders' views of their company. This may be achieved through a range of approaches, including face-to-face meetings, analysts' or brokers' briefings and surveys of shareholders' opinions.

Getting to know your major shareholders

Boards should gain an understanding of each of their major institutional shareholders and, where there is a fund manager representing them, the mandate(s) under which they manage the shares. This knowledge will give an invaluable insight into the likelihood of those investors holding the shares for the longer term. Fund managers whose performance is judged over a period of years rather than by reference to quarterly returns on their portfolio are, for example, less likely to be regularly trading the shares they manage. Similarly, tracker funds will be required to hold shares across all of a given index.

It will be helpful for the board to understand how their institutional shareholders monitor their holdings and approach governance issues. Some institutions employ a screening system based on financial performance and then look at the root cause of a problem, for example in strategy or governance, when performance falls below a specified financial benchmark. Others will follow up governance concerns irrespective of the strength of current financial performance and some will act on issues of strategic importance, say risk management. In such instances it is common to look at how well the matter is dealt with across a particular business sector in order to make comparisons with a peer group.

Despite the undoubted differences in approach, certain common themes do emerge among institutional investors and fund managers:

- ▶ Institutional investors and their fund managers do not want to micro-manage their investments but do want assurance that the board is actively directing and leading the company and they want to know that it is well managed.
- ▶ They want a company's board to have a clear strategy that it is able to articulate and deliver.
- ▶ Companies need to have a clear understanding of the principal risks that need to be managed if the business is to achieve its objectives.
- ▶ Remuneration packages should be genuinely aligned with shareholders' interests. There is a willingness to see outstanding performance well rewarded but concern that in some instances average, or slightly above average, performance has been attracting high payouts. There is also strong interest in making sure failure is not rewarded – investors will generally be suffering losses or low returns when this happens.

- ▶ Frustration exists at the amount of 'boilerplate', that is detailed but bland, disclosure in annual reports, especially in areas such as governance and risk management. This is coupled with an affirmation of the importance of the annual report and a desire for effective accountability and communication through it as to how the company is performing, how it is governed and how it is addressing the challenges it faces.
- ▶ There is a willingness, especially in the case of smaller listed companies, to accept some departures from the Code and not to treat them as breaches of good corporate governance. However, in such instances the companies are expected to provide clear justification for their actions.

Boards should take the above points into account and make sure that they are aware of the views of their major shareholders on issues such as strategy, performance, quality of leadership and boardroom remuneration. In certain instances, such as the appointment of a new chairman or CEO, they would be well advised to sound out the views of those investors in advance. As well as considering the views of current institutional shareholders, it can sometimes be worth talking to potential investors in order to obtain an alternative view. In the case of a larger listed company, potential investors might include any major institution that is unexpectedly light in its

Figure 8.1

Circumstances when institutional shareholders/agents may intervene

Intervention may occur in response to concern about:

- ▶ **strategy;**
- ▶ **operational performance;**
- ▶ **acquisition/disposal strategy;**
- ▶ **independent directors not holding executive management properly to account;**
- ▶ **internal controls failing;**
- ▶ **inadequate succession planning;**
- ▶ **unjustifiable failure to comply with the Combined Code;**
- ▶ **inappropriate remuneration levels/incentive packages/severance packages;**
- ▶ **a poor approach to corporate social responsibility.**

Source: Institutional Shareholders' Committee, The Responsibilities of Institutional Shareholders and Agents - Statement of Principles, 2002 (abridged)

Figure 8.2

Possible forms of intervention by institutional shareholders/agents

- ▶ holding additional meetings with management
- ▶ expressing concern through the company's advisers
- ▶ meeting with the chairman, senior independent director, all independent directors
- ▶ intervening jointly with other institutions
- ▶ making a public statement in advance of an AGM/EGM
- ▶ submitting resolutions at shareholders' meetings
- ▶ requisitioning an EGM, possibly to change the board

Source: Institutional Shareholders' Committee, The Responsibilities of Institutional Shareholders and Agents - Statement of Principles, 2002 (abridged)

holdings. The board should also keep up to date with financial, trade and other press coverage of the company together with the current range of views on the company's outlook in brokers' notes.

Large institutional shareholders will want direct contact with the company through presentations and one-to-one meetings. Subject to adhering to the requirements concerning the release of price-sensitive information, there should be a regular flow of information to the market with management available to respond to investors' questions after key announcements have been made. For example, after the announcement of preliminary results to the market at 7.00 am through a Primary Information Provider (PIP) there should normally be a range of follow-up presentations and meetings that day. Some companies will also follow these initial meetings with a roadshow to see other investors.

In addition to meetings with institutional shareholders, companies often arrange separate meetings with analysts. At all these events, they should make sure that they communicate their strategy and competitive strengths clearly and succinctly. Many companies also use site visits to provide investors and analysts with a greater insight into their business, to demonstrate new products and to allow them to meet other members of the senior management team.

The Institutional Shareholders Committee⁽¹⁾ has indicated the circumstances in which institutions may wish to discuss their concerns with an

investee company (see Figure 8.1). Its Statement of Principles goes on to outline the escalating form that such interaction may take depending on the response received (see Figure 8.2). The Committee has also set out the information available to companies from institutional investors – companies will find it helpful to obtain this both with respect to current and potential institutional shareholders (see Figure 8.3).

Foreign institutional ownership forms a growing element of the UK market and companies should ensure that the needs of their overseas shareholders are not overlooked. Market information should be made available to a global audience via the web or other forms of electronic distribution. Many companies are now making presentations of their results through conference calls and web casts allowing easy access regardless of location. Companies with an increasingly international shareholder base should make sure that they visit their overseas investors on a regular basis as well as actively inviting those institutions to domestic investor events.

Private investors

The Code focuses primarily on institutional investors but companies should be careful not to overlook private investors when organising their investor relations activities. Private investors can be especially important to smaller listed companies who may find it difficult to attract an institutional following. They can also be a very

loyal group of shareholders, with many relying on press comment and company communications for information on their holdings. On the downside, the cost per share of maintaining private investors on the share register, including sending them relevant information, can be much higher than for institutional counterparts because of their smaller average shareholdings.

Smaller listed companies may find it helpful to develop links with private client brokers in their areas in order to build a strong local following from private investors. Such moves can also be enhanced by developing good links with the regional financial press. Some companies seek to attract private investors by offering discounts on their products or services. Shareholder 'perks' such as these have proved a reliable way of building a following in the past in some instances but care needs to be taken that the cost of the discount remains reasonable.

Attracting institutional interest

There is no ideal balance on the shareholder register between institutional and private shareholders. It will depend on the company's circumstances including the current mix of shareholders the resources available to target new investors and whether the board wishes to source new capital in the near future.

Many smaller listed companies express concern about not being able to attract an institutional investor following. Without institutional interest, smaller company shares can suffer from low liquidity meaning that moderate share purchases or sales leads to volatility in the share price. There is no easy solution but the following may help in increasing institutional interest:

- ▶ ensure a sufficient 'free float' of shares so that there is a reasonable possibility of liquidity in the market;
- ▶ ensure the company is seen to be well governed with a skilled management team and well respected non-executive directors (where a family business, it will be important to persuade the market that directors are selected on grounds of merit);

- ▶ develop a credible strategy that offers significant potential for the company – growth is the main reason for institutional investors or their fund managers to take an interest in smaller listed companies;
- ▶ generate interest among analysts in the company, if possible securing it from analysts independent of the company's broker, ideally accompanied by published research;
- ▶ develop links with financial journalists, whether national, regional or from the trade press, and project the company in a way that targets the selected journalists' special interests; and
- ▶ follow the cardinal rule of not surprising the market, especially not with negative news.

Figure 8.3

Information available from institutional shareholders and their agents

A clear, publicly available policy statement on their approach to activism and how they will discharge their responsibilities including on issues set out below:

- ▶ **How investee companies will be monitored**
- ▶ **The policy on compliance with the Combined Code**
- ▶ **The policy for meeting with an investee's board and senior management**
- ▶ **How they will deal with situations where institutional shareholders/agents have a conflict**
- ▶ **Strategy on intervention**
- ▶ **Indication of circumstances when further action will be taken and possible types of action**
- ▶ **Voting policy**

Source: Institutional Shareholders' Committee, The Responsibilities of Institutional Shareholders and Agents - Statement of Principles, 2002 (abridged)

IR website

An investor relations website is a cost-effective way of providing easily-updated information at all times to all locations. It can also be accessed by all of a company's audiences. While it is not a substitute for the regulatory requirement of keeping the market informed through press releases via the PIP system, it can be an added communications channel providing access to investor presentations, analysts' meetings and site tours. E-mail alerts can also be used to send up-to-date news to investors and other interested parties.

Good IR websites should be a mixture of a briefing tool for those coming to the company for the first time; an ongoing information service for those with an established interest in it and an electronic library of corporate information. They also help to create a more level playing-field between institutional and private investors – the web grants all investors access to financial information as it is released. An indication of best practice website content suggested by the Investor Relations Society is shown in Figure 8.4.

Measuring IR performance

Like all other parts of the business, the return on the time and cost invested in the investor relations programme should be measured and managed. It is hard to gauge precisely the impact of an investor relations programme since it will ultimately be determined by its effect on the share price and increased interest in the company's stock. It may, for instance, have the effect of allowing the company to raise new capital on more competitive terms but, once again, it is difficult to compare before and after in such instances.

Notwithstanding this, it will be helpful to set measurable objectives. These might include:

- ▶ setting targets for the number of analysts and institutional investors to be visited in the year. The latter group could be broken down further into existing and potential investors;
- ▶ checking the amount and quality of coverage in national, regional and trade media;
- ▶ reviewing the number of analysts' research reports written on the company and the degree of support they show for the company's strategy, leadership and performance; and
- ▶ assessing whether the shareholder register moves in the desired direction over time, for example in terms of greater institutional involvement.

Promoting ongoing dialogue with institutions

Boards will find that investing time and resources into having an open, ongoing dialogue with current – and potential – institutional shareholders will more than justify the cost. A critical element of this dialogue will involve listening carefully to messages being relayed back to the board. Sometimes this may come indirectly through, say, an investor relations officer or agency but any feedback is to be ignored at the company's peril. A quality, ongoing dialogue with investors will put the company on the front foot rather than force it to spend time justifying or reversing decisions that have failed to command support. Communication will also help to build a high level of trust and understanding in the relationship between the board and investors. Current and prospective shareholders not only supply the company's capital – they also determine its value.

Figure 8.4

IR best practice - site content

General

- ▶ A clear statement of strategy and vision.
- ▶ Corporate profile including analysis of the company's principal markets.

Financial Data

- ▶ Annual Report, interim, preliminary and quarterly statements.
- ▶ Archived financial information for a minimum of three years. Five to ten years history of key P&L data.
- ▶ Key financial ratios should be on the site – including return on capital employed or return on net assets, cash flow per share, discounted cash flow per share, earnings per share, updated P/E ratios and margin information.
- ▶ Relevant information on the main intangibles of the business, for example, brands and human capital.

Corporate governance & corporate social responsibility (CSR)

- ▶ Information related to application of/compliance with the Combined Code.
- ▶ Comprehensive information on the company's CSR policies including the policy objectives for each CSR area with quantified progress towards their achievement. A note of any pending litigation on health and safety/other socially responsible investment matters.

Shareholder information

- ▶ Shareholding analysis by size and constituent. Details of percentage shareholding of principal shareholders.
- ▶ AGM reporting, including votes for and against each resolution.
- ▶ Information on directors' share dealings.
- ▶ Brokers' consensus earnings forecasts and a list of analysts covering the company's stock.

Relevant news

- ▶ Access to all news releases and to presentations, speeches, reports and articles by key executives.
- ▶ Access to electronic filings, for example those filing with SEC using the EDGAR system.
- ▶ Identification of financial sites carrying specific company data.

Source: Investor Relations Society website – best practice section

References

(1) Institutional Shareholders Committee, *The Responsibilities of Institutional Shareholders and Agents – Statement of Principles, 2002*

(2) *Investor Relations Society website – best practice section*

This chapter also draws on advice contained in 'Investor Relations – A Practical Guide' published by the London Stock Exchange and Buchanan Communications

Online resource centre



Association of British Insurers www.abi.org.uk

The investment affairs section contains the ABI's *Corporate Governance Guidelines on Executive Compensation and Share Based Remuneration*, *Corporate Governance and Social Responsibility* as well as the Institutional Shareholders' Committee statement on the *Responsibilities of Institutional Shareholders and Agents – Statement of Principles*.

Business in the Community www.bitc.org.uk

The resources section contains a toolkit, updates on developments in the responsible business practice agenda and details on their *Corporate Responsibility Index* and *Corporate Reporting Impact Initiative*.

CBI www.cbi.org.uk

The website includes CSR case studies which are updated each quarter.

Conference Board www.conference-board.org

Details are included on a number of reports and briefings on boardroom issues, principally from a US perspective, including *Corporate Governance Best Practices*, *A Blueprint for the Post-Enron Era*.

Department of Trade and Industry www.dti.gov.uk

Resources include research data on listed company boards (produced as part of the *Higgs Report*), the *Director's Remuneration Report Regulations*, the *Accounting for People* report and guidance on corporate social responsibility.

Financial Reporting Council www.frc.org.uk

The FRC website contains the *Combined Code on Corporate Governance*. The related Accounting Standards Board and Auditing Practices Board websites can also be accessed from here.

Global Reporting Initiative www.globalreporting.org

The website includes information on the *GRI Reporting Framework* covering the latest guidelines, technical protocols, sector supplements and details on organisations using the guidelines.

Institute of Chartered Accountants in England and Wales www.icaew.co.uk

The Institute's series of booklets on audit committees can be downloaded from the corporate governance area of the technical policy section of the website.

Institute of Internal Auditors www.iaa.org.uk

The website includes a useful briefing for the audit committee on *Appraising Internal Audit* and a benchmark audit charter setting out the purpose, responsibilities and powers of the internal audit department.

Investor Relations Society www.ir-soc.org.uk

The IR best practice section of the website contains comprehensive guidelines on best practice in online investor relations.

London Stock Exchange

www.londonstockexchange.com

Providing a comprehensive guide to the London Stock Exchange and an important source of information, amongst other things, on how companies can maximise the benefit of being on one of our markets. The Practical Guide series can be ordered through the Exchange website.

National Association of Pension Funds

www.napf.co.uk

The website includes details on the NAPF's 2004 *Corporate Governance Policy* which provides the framework for the NAPF's voting guidelines.

RSM Robson Rhodes LLP www.rsmi.co.uk

The RSM Robson Rhodes website contains a number of corporate governance resources including the results of the *Board Effectiveness Survey* and of the *Investment Trust Board Effectiveness Survey* as well as a downloadable version of the RSM International publication *Building World Class Boards*. A copy of Malcolm McKenzie's lecture to the Institution of Mechanical Engineers on strategic issues can also be downloaded from the website.

World Economic Forum www.weforum.org

Contains information on a number of initiatives including *Corporate Governance Dialogue* and *Global Corporate Citizenship*. The latter section contains the report '*Values and Value, Communicating the Importance of Corporate Citizenship to Investors*'.

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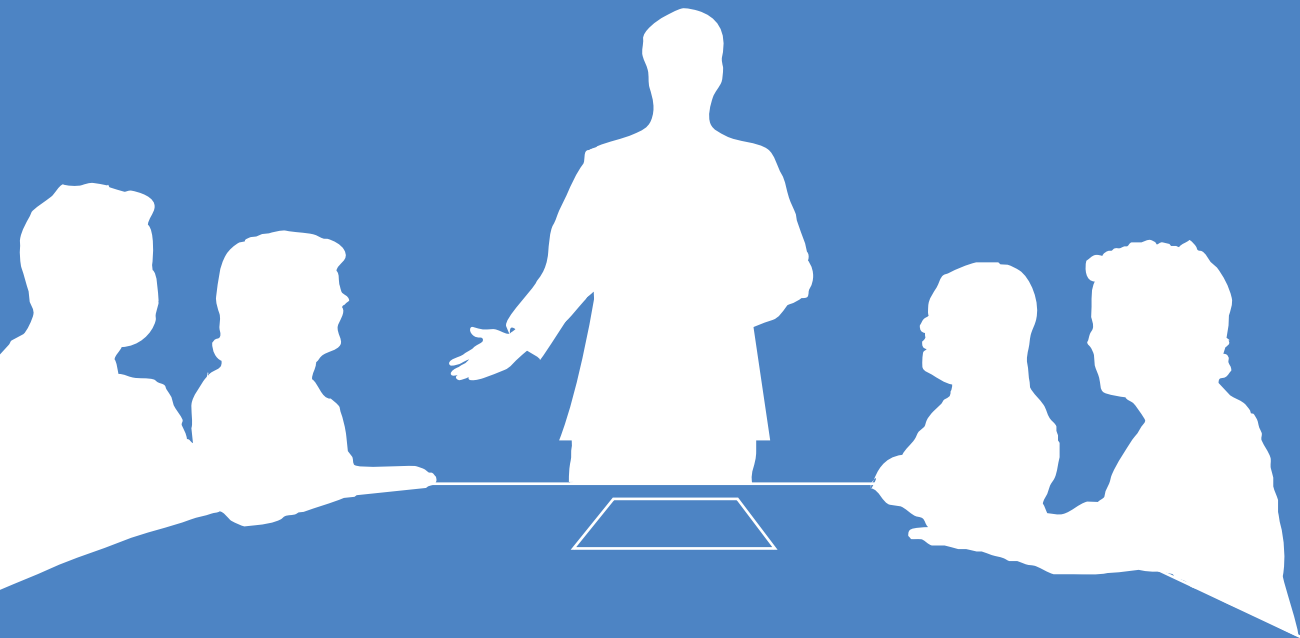
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