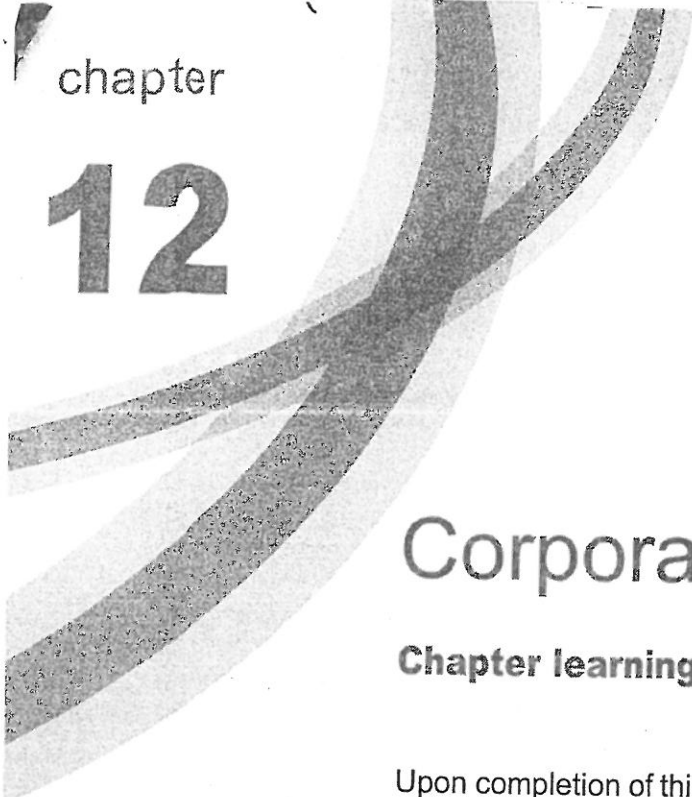




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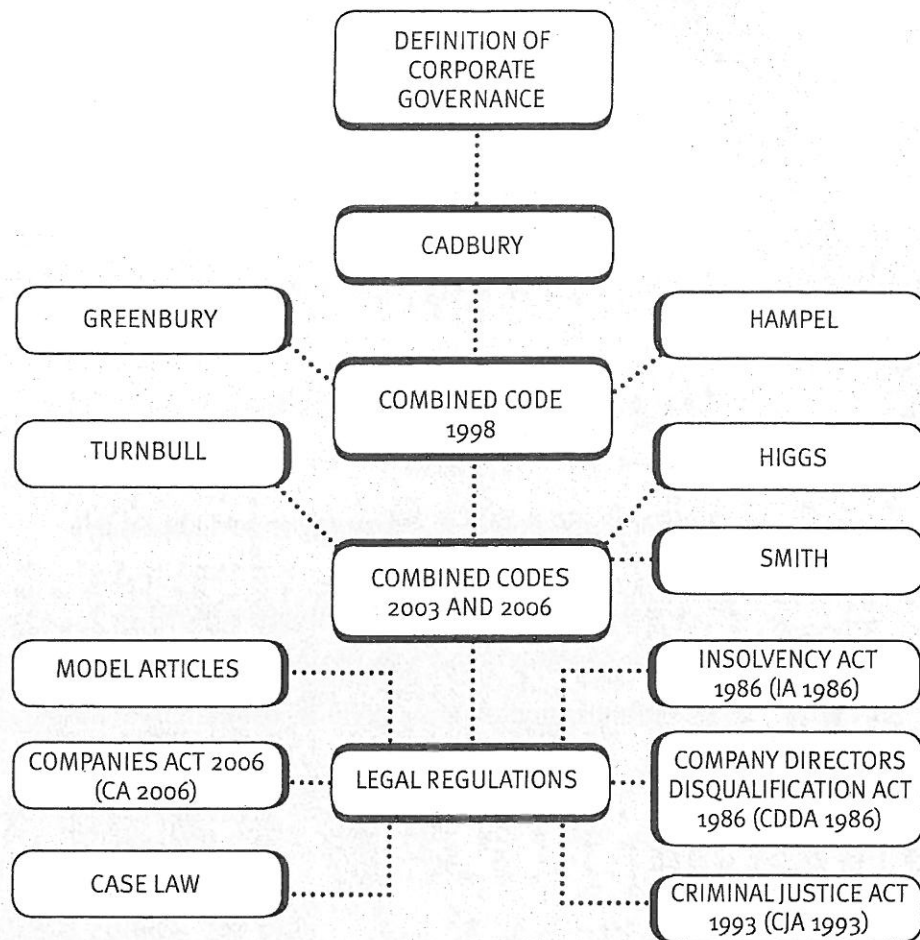
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Corporate governance

Chapter learning objectives

Upon completion of this chapter you will be able to:

- explain the idea of corporate governance
- recognise the extra-legal codes of corporate governance
- identify and explain the legal regulation of corporate governance.



1 Introduction

Definition



Corporate governance is the system by which companies are directed and controlled.

It covers topics such as:

- how power is divided between the board and the shareholders
- the accountability of the board to the members
- the rules and procedures for making decisions.

Corporate governance provides the structure through which the company's objectives are met, the means of attaining those objectives and monitoring performance.

Interaction of ethics, governance and company law

	Compliance requirements	Penalties
Law	The law must always be obeyed.	Penalties for infringement of the law may be civil or criminal. Civil remedies may allow the company to recover funds from directors who breach their legal obligations. A fine and/or imprisonment might result from certain criminal infringements.
Corporate governance	The stock exchange rules require listed companies to comply with the Combined Code (see below). If a listed company does not comply, it must specify the provisions with which it has not complied, and give reasons for its non-compliance. Unlisted companies are under no obligation to comply, although it is considered best practice to do so.	There are no formal penalties for non-compliance. However, the company may suffer loss of reputation and receive bad publicity.
Ethics	It is said that ethics begin where the law ends. If an action is legal, individuals generally have freedom of choice as to their conduct. However, good ethical behaviour may be above that demanded by the law. Accountants are expected to follow the code of ethics published by their professional body.	An individual who behaves unethically may suffer loss of reputation, dismissal from their job and sanctions may possibly be imposed by their professional body.



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The need for corporate governance

During the late 1980s a number of large UK public companies failed, some of them as a result of large-scale fraud by their directors.

These failures reduced public confidence in financial reporting and auditing. Many people believed that company directors regarded accounting standards as a set of rules to be circumvented and 'creative accounting' was implicated in several company liquidations:

- Directors were pressurising auditors to accept the use of 'creative accounting' schemes. As the auditors often received extra remuneration from the company for consultancy work, disagreement with the directors in the audit process could result in the loss of this additional income. This situation often compromised the auditors' independence.
- There was no clear framework for ensuring that directors reviewed internal controls in their companies.
- There was a perceived lack of accountability for excessive directors' remuneration.

A need to strengthen the systems of corporate governance used by UK companies was perceived. This need led to the establishment of the Cadbury Committee, which is considered in the next section.



Test your understanding 1

Which one of the following is correct?

- A It is a criminal offence for listed companies to fail to comply with the Combined Code.
- B A listed public company has complied with the Combined Code if it produces a report explaining why it has not complied with its recommendations.
- C The Combined Code has no status and may be ignored by all companies.
- D A public company may be sued for breach of statutory duty if it fails to comply with the Combined Code.

2 The history of corporate governance in the UK



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The Cadbury Committee

Set up by?	The Financial Reporting Council (FRC), the London Stock Exchange and the accountancy profession.
Objective	To help raise the standards of corporate governance and the level of confidence in financial reporting and auditing by setting out clearly the respective responsibilities of those involved and what was expected of them.
Publication	A Code of Best Practice (1992) was designed to achieve the necessary high standards of corporate behaviour.
Recommended	• It is desirable to separate the role of chief executive and chairman. • The board should include sufficient non-executive directors (NEDs) for their views to carry significant weight. • An audit committee should be appointed to review the financial statements before their submission to the full board. • A remuneration committee consisting wholly or mainly of NEDs should set the remuneration of executive directors. • The imposition of a three-year maximum term on executive directors' service contracts.
Outcome	The Stock Exchange required all listed companies to state whether or not they had complied with the Code and to give reasons for any areas of non-compliance. It also required the company's statement of compliance to be reviewed by the auditors before publication.

The Greenbury Report

Set up by?	The CBI in 1995.
Objective	To draw up guidelines on directors' remuneration, which was perceived to be excessive and did not seem to be linked to the company's performance.
Publication	A code of best practice in determining and accounting for directors' remuneration.
Outcome	All listed companies registered in the UK were required to comply with the Code. Their annual reports had to include a statement about their directors' remuneration. Any areas of non-compliance had to be explained and justified.

The Hampel Report

Issued	January 1998.
Objective	To restrict the regulatory burden facing companies and substitute broad principles (rather than detailed regulations) where practicable.
Summary	A board must not approach the various corporate governance requirements in a compliance mentality: the so-called 'tick-box' approach. Good corporate governance is not achieved by satisfying a checklist. Directors must comply with the substance as well as the letter of all best practice pronouncements.
Outcome	After publishing its report, the Hampel Committee drew up a single Combined Code of Best Practice, incorporating the Cadbury, Greenbury and Hampel recommendations.

The 1998 Combined Code

Objective	To combine the accepted principles and best practice guidelines of Cadbury, Greenbury and Hampel into a single code.
Outcome	The Stock Exchange Listing Rules require a listed company in the UK to include the following in its annual report and accounts: • A narrative statement of how it has applied the principles set out in the Combined Code, providing explanation which enables its shareholders to evaluate how the principles have been applied. • A statement as to whether or not it has complied throughout the accounting period with the Combined Code provisions. If it has not complied, it must specify the provisions with which it has not complied, and give reasons for any non-compliance. This approach to compliance is known as 'comply or explain'.

The Turnbull Report

Issued	In 1999 by the ICAEW.
Objective	To give additional guidance to listed companies on how to implement the provisions of the Combined Code dealing with internal control.
Summary	• The board should look forward and not just consider past performance. • Companies should keep their shareholders informed about risks. • Directors should be aware that the company must continually adapt to its changing environment. • Risks should be reviewed regularly.
Outcome	The Turnbull Guidance is appended to the 2003 Combined Code.

The Higgs Report

Issued	2003.
Objective	To develop guidelines for making NEDs more effective.
Outcome	Most of the report's recommendations were either written into the 2003 Combined Code or included in the best practice guidelines that are appended to it.

The Smith Report

Issued	2003.
Objective	To give guidance to company boards in making suitable arrangements for their audit committees and to assist directors serving on audit committees in carrying out their role.
Outcome	The report's recommendations are appended to the 2003 Combined Code.



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The role of the NEDs

At the time of the Cadbury Report, there was a history in the UK of public companies being dominated by an all-powerful chief-executive/chairman. In addition, NEDs, where they existed at all, were often heavily outnumbered by executive directors.

The Cadbury Report recommended the separation of the roles of chief executive and chairman, although it did not state that the same person could never be both. The role of the chief executive is to take charge of the executive management and the company's business operations; the role of the chairman is to manage the board of directors.

Cadbury recommended that there should be sufficient independent NEDs for their views to carry sufficient weight. As their independence might be put at risk if they had to rely on the chairman or chief executive for their appointment, Cadbury recommended that initial interviews should be conducted through a nominations committee.

The role of the NEDs is to bring judgement and experience to the board that the executive directors might lack. In contrast to the executive directors, NEDs do not usually have a full-time relationship with the company. They are not employees and only receive directors' fees. They are expected to exert a measure of control over the executive directors to ensure that they run the company in the company's best interests (rather than their own). They should scrutinise the performance of management in meeting agreed goals and objectives and monitor the reporting of performance.

They are also responsible for determining appropriate levels of remuneration for the executive directors.

Note that as far as company law is concerned, there is no distinction between executive directors and NEDs. Both are subject to the same controls and liabilities.

3 The Combined Code on Corporate Governance

History

The Combined Code on Corporate Governance was first issued in 1998. It consisted of principles and provisions (best practice).

A revised version of the Code was issued in 2003. This revised Code consisted of main principles, supporting principles and provisions (practical requirements).

The most recent version, which applies to reporting years beginning on or after 1 November 2006, was issued by the Financial Reporting Council in June 2006. None of the main principles have been changed. There were a few minor changes, which are outlined later.

Contents

The Code is divided into two sections:

- Section one is for companies
- Section two is for institutional shareholders.

The section for companies is subdivided into four areas:

- directors
- directors' remuneration
- accountability and audit
- relations with shareholders.

The Code has three appendices:

- the Turnbull Guidance on internal audit
- the Smith Guidance on audit committees
- the Higgs Guidance on best practice.

The main principles of each section are outlined below.

Directors

- (1) Every company should be headed by an effective board, which is collectively responsible for the success of the company.
- (2) There should be a clear division of responsibilities at the head of the company between the running of the board and the executive responsibility for the running of the company's business. No one individual should have unfettered powers of decision.
- (3) The board should include a balance of executive directors and NEDs (and in particular independent NEDs), such that no individual or small group of individuals can dominate the board's decision taking.
- (4) There should be a formal, rigorous and transparent procedure for the appointment of new directors to the board.
- (5) The board should be supplied in a timely manner with information in a form and of a quality appropriate to enable it to discharge its duties. All directors should receive induction on joining the board and should regularly update and refresh their skills and knowledge.
- (6) The board should undertake a formal and rigorous annual evaluation of its own performance and that of its committees and individual directors.
- (7) All directors should be submitted for re-election at regular intervals, subject to continued satisfactory performance. The board should ensure planned and progressive refreshing of the board.

Directors' remuneration

- (1) 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 this purpose. A significant proportion of executive directors' remuneration should be structured so as to link rewards to corporate and individual performance.
- (2) There should be a formal and transparent procedure for developing policy on executive remuneration and for fixing the remuneration packages of individual directors. No director should be involved in deciding his or her own remuneration.

The Code provides that service contracts and notice periods should not exceed one year.

Accountability and audit

- (1) The board should present a balanced and understandable assessment of the company's position and prospects.
- (2) The board should maintain a sound system of internal control to safeguard shareholders' investment and the company's assets.
- (3) The board should establish formal and transparent arrangements for considering how they should apply the financial reporting and internal control principles and for maintaining an appropriate relationship with the company's auditors.

The Code provides that the board should establish an audit committee of at least three (or in the case of smaller companies two) members, who should all be independent non-executive directors. The board should satisfy itself that at least one member of the audit committee has recent and relevant financial experience.

The committee should meet at least three times during the year at times coinciding with key dates within the financial reporting and audit cycle.

Relations with shareholders

- (1) There should be a dialogue with shareholders based on the mutual understanding of objectives. The board as a whole has responsibility for ensuring that a satisfactory dialogue with shareholders takes place.
- (2) The board should use the annual general meeting (AGM) to communicate with investors and to encourage their participation.

Institutional shareholders

- (1) Institutional shareholders should enter into a dialogue with companies based on the mutual understanding of objectives.
- (2) When evaluating companies' governance arrangements, particularly those relating to board structure and composition, institutional shareholders should give due weight to all relevant factors drawn to their attention.
- (3) Institutional shareholders have a responsibility to make considered use of their votes.

The 2006 Combined Code

The FRC issued a new version of the code on 27 June 2006. The new version contains a few changes, e.g.:

- The restriction on a company chairman serving on a remuneration committee has been relaxed. However, it is still recommended that the chairman should not chair the committee.

- A 'vote withheld' option should be included on proxy forms so that investors can indicate reservations about resolutions that they do not wish to vote against.
- A recommendation that companies publish on their website the details of proxies lodged at a general meeting where votes are taken on a show of hands.

Both the 2003 and 2006 versions of the Combined Code are available online at www.frc.org.uk/corporate/combinedcode.cfm

Rules-based versus principles-based approaches to governance

The Combined Code is a set of principles, rather than a set of rules. It requires directors to describe in their own words the way in which they have applied the general principles of corporate governance.

A principles-based approach to governance has the following advantages and disadvantages.

Advantages

- Because the directors report on the actual circumstances of their own company, the report should be more meaningful than one based on specific detailed requirements.
- A code of practice can be changed much more easily than statutory requirements. This means that the Combined Code can be updated to respond to changing conditions and changing expectations of shareholders and others.
- A principles-based approach encourages the directors to follow the spirit of the Code; whereas a rules-based approach may result in a tick-boxes mentality. This means that under a rules-based approach the directors may follow the letter of the rules, rather than their spirit.

Disadvantages

- A principles-based approach tends to result in general, meaningless statements.
- It may be difficult for the directors to see whether they have met the specific requirements of the Code.



Test your understanding 2

- A Define the term 'corporate governance'. (Your answer must not exceed 15 words.)**
- B Which three reports are appended to the current Combined Code?**
- C Complete the gaps. The following persons cannot be regarded as independent:**
- anyone who has been an employee of the company in the previous years.
 - anyone who has had a material business relationship with the company in the previous years.
 - anyone who has served on the board for more than years.
- D Complete the following sentence in no more than 20 words:**

The Stock Exchange rules require listed companies to comply with the Combined Code. If it does not comply, the company must...

4 The legal regulation of corporate governance

Introduction

The legislation covering corporate governance has been covered in earlier chapters. The following table gives you an indication of where to find the relevant provisions:

Model articles	Set out the internal constitution of the company, e.g. allowing the company and/or the board to negotiate directors' service contracts.
CA 2006	Provides the main framework for the legislation affecting companies. Specifies that a director's service contract cannot exceed two years unless first approved by the members. Specifies the duties that directors owe to their companies.
IA 1986	Established liability for wrongful and fraudulent trading. Permits the liquidator to set aside transactions at an undervalue or where the company has given a preference.

Corporate governance

COMPANY
DIRECTORS
DISQUALIFICATION
CT

CRIMINAL
JUSTICE
CT

CDDA 1986	Allows the court to disqualify someone from being a director if they: • have persistently breached the companies legislation • are found to be unfit, or • are convicted of an indictable offence in connection with the promotion, formation, management or liquidation of a company.
CJA 1993	Contains the legislation on insider dealing.

The Sarbanes-Oxley Act 2002

The Sarbanes-Oxley Act 2002 is a US law that applies to all companies (including foreign companies) that have a listing on the US stock exchange.

It was introduced in the wake of corporate scandals such as the unexpected collapse of Enron and WorldCom.

The US approach to corporate governance is a statutory rules-based one. This differs from the UK where it is principles-based with an emphasis on voluntary compliance. The Sarbanes-Oxley Act requires all companies with a listing in the US to include in their annual report a certificate vouching for the accuracy of the financial statements. This certificate must be signed by the company's principal executive officer and principal financial officer.



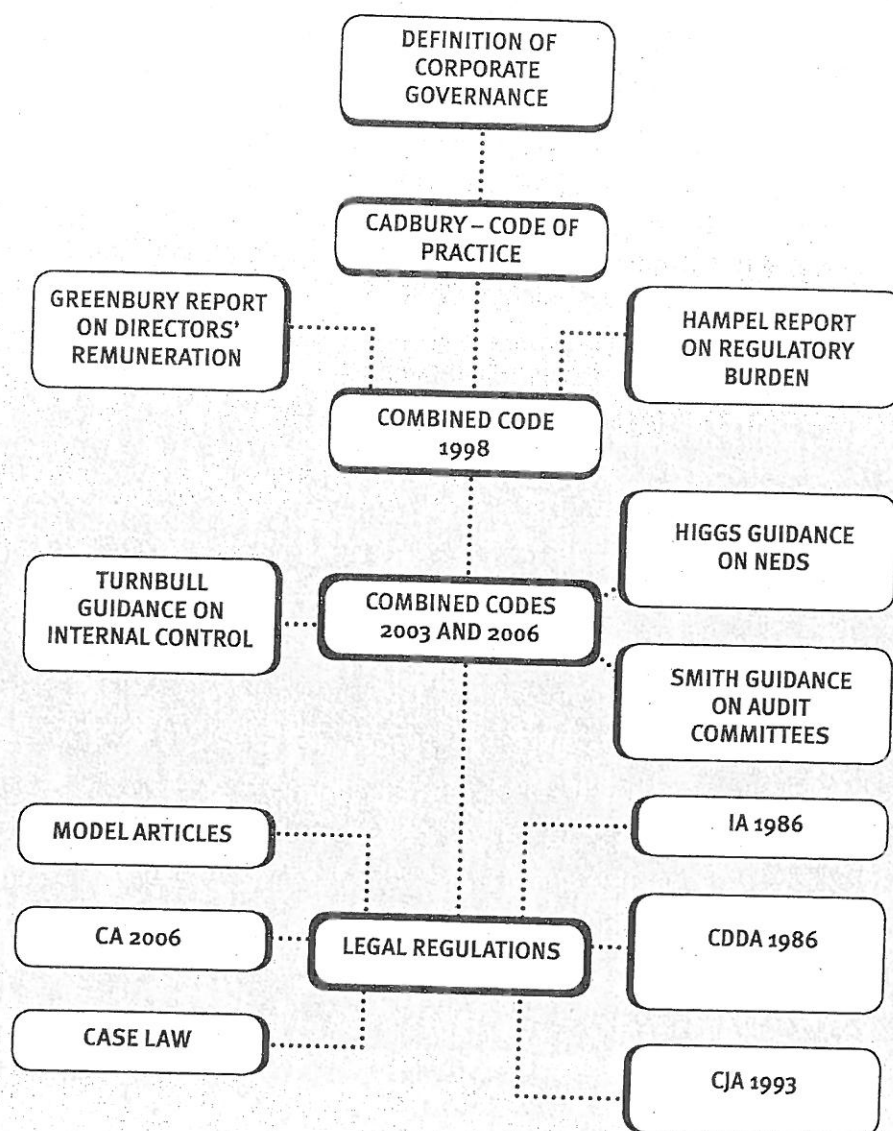
Test your understanding 3

A What is the maximum permitted length of a director's service contract according to:

- I the Companies Act 2006
- II the Combined Code?

B To which companies does the Sarbanes-Oxley Act apply?

5 Chapter summary



Test your understanding answers



Test your understanding 1

- B The Combined Code is not legislation. It is therefore not mandatory. Companies are required to either comply with the Code or explain why they have not done so. Therefore a company which explains why it has not complied with the Code's recommendations would nonetheless be complying with it!



Test your understanding 2

- A Corporate governance is the system by which companies are directed and controlled.
- B Turnbull, Higgs and Smith.
- C The following individuals cannot be regarded as independent:
- anyone who has been an employee of the company in the previous **five** years
 - anyone who has had a material business relationship with the company in the previous **three** years
 - anyone who has served on the board for more than **nine** years.
- D The Stock Exchange rules require listed companies to comply with the Combined Code. If it does not comply, the company must specify the provisions with which it has not complied, and give reasons for its non-compliance



Test your understanding 3

- A The maximum permitted length of a director's service contract is:
- I two years according to the Companies Act 2006
 - II one year according to the Combined Code.
- B The Sarbanes-Oxley Act applies to all companies (including foreign companies) that have a listing on the US stock exchange.

The role of the audit committee

Answers might include aspects of the following: possibly providing facts with commentary as to the contribution of the audit committee.

1. Composition of audit committees

- Sub-committee of main board, composed exclusively/predominantly of non-executive directors but with finance director and representatives of internal and external auditors in attendance.
- The members should be free of any relationship which would interfere with the exercise of independent judgement.
- Difficult to achieve when appointed by the directors

2. Responsibilities

- Provide an independent oversight of the organisation's systems of internal control and financial reporting process.
- Reviewing financial statements and accounting principles and practices adopted
- Liaising with internal and external auditors
- Monitor relationships with external auditors, to ensure that there are no restrictions on the scope of the statutory audit
- Make recommendations on the auditors appointment, remuneration and dismissal
- Review the activities, findings, conclusions and recommendations of external auditors
- Approve the appointment and termination of head of internal audit who should have a right of direct access to the chair of the audit committee at all times
- Review the scope and nature of the work of internal audit, review reports from head of internal audit and on occasion to commission audit assignments to be conducted on the committees behalf
- Reviewing the effectiveness of internal controls and risk management systems

3. Benefits of audit committees

Assist directors to meet statutory and fiduciary responsibilities

Prevent domineering chief executives abusing their power

Facilitate communication between auditors and board of directors

Act as a filter of information

Non-executives bring their wider business knowledge to bear on accounting, audit and internal control issues

Easier for auditors not to be subject to undue influence by management

Increase credibility and objectivity of financial reports

4. Criticisms of audit committees

Formed merely to provide an appearance of monitoring

Non-executives not necessarily impartial

Diversion of non-executives from their strategic role

Non executives often have a number of positions and do not devote sufficient time

No requirement for **all** members to have accounting/audit qualifications

Do not appear to be effective where domineering CEO (eg Tomkins plc)

5. Improvements

Include non-board members who might be more objective

Change appointment procedure (subject to election by shareholders)

[Home](#) > [Our Work](#) > [Codes & Standards](#) > [Corporate Governance](#) > [UK Corporate Governance Code](#)

UK Corporate Governance Code

UK Corporate Governance Code (formerly the Combined Code) sets out standards of good practice in relation to board leadership and effectiveness, remuneration, accountability and relations with shareholders.

All companies with a Premium Listing of equity shares in the UK are required under the Listing Rules to report on how they have applied the Code in their annual report and accounts. The relevant section of the Listing Rules can be found at: <http://fsahandbook.info/FSA/html/handbook/LR/9/8>.

The Code contains broad principles and more specific provisions. Listed companies are required to report on how they have applied the main principles of the Code, and either to confirm that they have complied with the Code's provisions or - where they have not - to provide an explanation. Some of the provisions of the Code require disclosures to be made in order to comply with them. These are summarised in Schedule B to the Code.

The new edition of the Code was published in September 2012 and applies to reporting periods beginning on or 1 October 2012.

Companies reporting on reporting periods beginning before 1 October 2012 should continue to report against the June 2010 edition of the Code, although they are encouraged to consider whether it would be beneficial to adopt some or all of the new provisions in the revised code earlier than formally expected.

The FRC also publishes guidance to boards and board committees to assist them in considering how to apply the Code to their particular circumstances. There are different pieces of guidance addressing board effectiveness, the role of the audit committee, risk management and internal control and going concern and financial reporting.

The Code and guidance can be downloaded from this website. Printed copies can be obtained free of charge from FRC publications, tel: 020 8247 1264, email: customer.services@cch.co.uk and online at: www.frcpublications.com.

2012 changes to the Code

The revised Code issued in September 2012 follows a consultation exercise seeking views on whether to amend the UK Corporate Governance Code and the associated Guidance on Audit Committees.

The differences between the 2010 and 2012 editions of the Code are summarised in the Appendix to the feedback statement on that consultation.

[Click here to view the Consultation document and responses to the consultation.](#)

The revised Code also incorporates changes originally announced in October 2011 following consultation on whether it intended to amend the UK Corporate Governance Code to require companies to publish their policy on boardroom diversity and report against it annually, as recommended by Lord Davies in his 'Women on Boards' report published in February 2011.

Consultation Document: Gender Diversity on Boards (May 2011)

Feedback Statement: Gender Diversity on Boards (October 2011)

[Click here to view the responses to the consultation exercise.](#)

Audit Tendering

One of the new provisions in the 2012 edition of the Code states that FTSE 350 companies should put the external audit contract out to tender at least every ten years.

The FRC recognises that the audit market could be disrupted if a large number of companies chose to go out to tender in the first year in which the revised Code applied. When consulting on the proposal, the FRC therefore put forward some possible *transitional arrangements*. These were broadly endorsed and are set out below.

The suggested transitional arrangements are not binding. Companies should put the audit contract out to tender earlier than they would be expected to under these arrangements if they feel it is appropriate to do so, and shareholders should feel free to request them to do so. Equally, as with all other provisions of the Code, companies can choose not to comply and explain why not. Whatever their decision, the FRC would encourage companies to state when they first report against the 2012 Code whether or not they anticipate putting the audit contract out to tender in due course.

The FRC suggested that the timing of tenders might be aligned with both the cycle for rotating the audit engagement partner and the length of time since the audit contract was previously put out to tender. The FRC suggested that where a company has put the audit contract out to tender or changed audit firm in or after 2000, the tender process might be deferred until the latter stages of the incoming audit engagement partner's term (in other words, for a further five years).

So, for example, under these suggested arrangements, if the current audit partner was due to complete their five year period in 2014 the company would carry out a tender in time for the successful audit firm (which could be the incumbent firm) to take up their appointment when that partner steps down. However if the company had carried out a tender or changed audit firm more recently than 2000, this could be deferred until the next partner rotation in 2019.

Explanations

It is important that companies provide clear and meaningful explanations when they choose not to apply one of the provisions of the Code, so that their shareholders can understand the reasons for doing so and judge whether they are content with the approach the company has taken.

In February 2012 the FRC published a paper titled What Constitutes an Explanation under 'Comply or Explain'? which identified a number of features of a meaningful explanation. These included, for example, providing a clear rationale for the action taken and describing any mitigating actions.

These features have now been incorporated in the introductory section of the 2012 edition of the Code. The FRC believes that it will be helpful for companies to understand what is expected of them and for shareholders to have a benchmark against which to assess explanations.

Monitoring

In December 2011 the FRC published a report called Developments in Corporate Governance 2011. This was the first of what is intended to be a series of annual reports on the impact and implementation of the UK Corporate Governance and Stewardship Codes. The 2012 report is available here, and the next report is scheduled to be published in December 2013.

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FRC publishes updates to UK Corporate Governance Code

PN 010

Following consultation in April, the Financial Reporting Council (FRC) has made changes to the UK Corporate Governance Code and Stewardship Code to improve transparency and engagement through the investment chain. Both Codes will continue to operate on a 'comply or explain' basis.

Changes to the UK Corporate Governance Code include:

- FTSE 350 companies are to put the external audit contract out to tender to achieve the aim of ensuring a high quality and effective audit, whether from the same or a different firm. The FRC will be holding discussions with companies, and will issue guidance on tendering would be useful;
- Audit Committees are to provide to shareholders information on how they discharge their responsibilities, including how they have assessed the effectiveness of the audit;
- Boards are to confirm that the annual report and accounts taken as a whole are clear, understandable, to ensure that the narrative sections of the report are consistent with the financial statements and accurately reflect the company's performance;
- Companies are to explain, and report on progress with, their policies on climate change where a change was first announced in October 2011, but its implementation was delayed or changes to the Code have been made;
- Companies are to provide fuller explanations to shareholders as to why they have not complied with a provision of the Code.

Changes to the Stewardship Code include:

- Clarification of the respective responsibilities of asset managers and asset owners for stewardship activities that they have chosen to outsource;
- Investors are to explain more clearly how they manage conflicts of interest and how they will take part in collective engagement, and the use they make of engagement;
- Asset managers are encouraged to have the processes that support their stewardship activities independently verified, to provide greater assurance to their clients.