

GOOD GOVERNANCE, GOOD BUSINESS SENSE

Revolutions, earthquakes and bank collapses are no longer the preserve of the latest Hollywood blockbuster action movie. They are the stuff of day-to-day challenge for many directors. Keeping pace with an ever-increasing range of risks, and of stakeholders' expectations, is putting pressure on even the best run boards, as **Bob Semple** explains.

The purpose of this article is to outline a high-level perspective of the latest corporate governance requirements with reference particularly to the Corporate Governance Code and the Irish Stock Exchange Annex. Directors will need to consider the specific obligations facing them under all relevant legislation and regulation, but this article should provide a useful starting point.

CORPORATE GOVERNANCE CONCERNS

A formal review of corporate governance by Sir David Walker (examining the financial collapse) and by the Financial Reporting Council (FRC) (looking at governance more generally) concluded that the existing (2008) 'Combined Code' is effective and that the 'comply or explain' approach is sufficiently flexible to embrace different companies' circumstances. But it did identify some common concerns:

Role of Non-Executive Directors

Were they sufficiently robust in their challenge to management? Did they spend sufficient time in the business to enable them to fully understand the business and ask the necessary probing questions?

Board balance

Was there sufficient expertise (as opposed to independence)?

Board accountability

Was there effective engagement between



Boards and investors? What were the investors doing to hold Boards to account for their actions?

Risk

On risk, did some Boards lose sight of the level of risk being taken? Was risk oversight undertaken by the Board, or delegated to the audit committee or the risk committee?

Pay

Was reward linked to the long term interests of the company? Were remuneration policies linked to the company's strategy?

KEY CHANGES IN GOVERNANCE REQUIREMENTS

In May 2010, the FRC published the revised UK Corporate Governance Code (the 'Code') to replace the 2008 Combined Code. It addressed the concerns raised above although it did not incorporate recommendations uniquely applicable to the financial services sector. At one level, it left the Code substantially unchanged. Closer examination, however, reveals some significant shifts of expectation, as set out in Table 1.

In Ireland, for periods beginning on or after 30 September 2010 the Irish Stock Exchange's Listing Rules require compliance with the Code.

GUIDANCE ON APPLYING THE CODE

The Code does not stand alone, however; in practice, it should be read alongside complementary guidance. It is surprising just how much guidance of this type exists.

Guidance on Board Effectiveness (formerly Higgs Guidance) – 2011

This guidance is designed to help companies apply the sections of the Code that deal with leadership and Board effectiveness. It focuses on Board behaviours rather than process. It covers areas such as: the roles of the chairman, senior independent director, other Directors and the company secretary; decision-making policies and processes; Board composition and succession planning; and performance evaluation.

Guidance on Audit Committees (formerly Smith Guidance) – 2010

This guidance helps Boards implement the sections of the Code dealing with the audit

Table 1

Key changes in the Governance Code

- ▶ Clearer provisions on the importance of the chairman's role in leading the Board and the responsibility of the Non-Executive Directors (NEDs) to provide constructive challenge.
- ▶ Annual re-election of Chairmen and of the Chair of the Remuneration Committee if the vote on the remuneration report attracts a vote of less than 75% in favour (FTSE 350 companies¹)
- ▶ Change of emphasis on the criteria for selecting NEDs so that a lack of independence (in particular, due to length of tenure) should not be considered an impediment for re-election where the individual brings skills, experience and knowledge to the Board.
- ▶ Greater emphasis on the ongoing development of Directors including a recommendation that all Directors have the opportunity to increase their knowledge of the company's business through access to staff and operations and that the chairman regularly reviews and agrees each director's training and development needs.
- ▶ An annual evaluation of their performance with external facilitation at least every three years (FTSE 350 companies¹).
- ▶ More explicit guidance on risk with a provision outlining the Board's responsibility for determining the extent and nature of the significant risks that the Board is willing to take to achieve its strategic objectives (its 'risk appetite') and for maintaining a sound risk management system.
- ▶ Clarification of provisions dealing with remuneration to emphasise the need for performance-related elements to be aligned with the long-term interests of the company.
- ▶ Provision for ensuring that remuneration is consistent with the company's risk policies and for consideration of arrangements for claw back of incentives in certain limited circumstances.

¹ The Irish Stock Exchange equates FTSE 350 companies with companies trading on the Main Securities Market which are not eligible for inclusion in the ISEQ Small Cap Index and FTSE 100 companies with Irish companies which trading on the Main Securities Market with market capitalisation of €2 billion or above.

committee and external auditors and how Directors serving on audit committees should carry out their role. It addresses the audit committee's membership, procedures and resources, its relationship with the Board, its role and responsibilities in financial reporting, internal financial control, risk management systems, whistleblowing, the internal and external audit process, and its communication with shareholders

Update for Audit Committees: issues arising from current economic conditions - Nov 2010

The FRC issued this paper to help direct

audit committees' focus by posing key questions concerning the impact of the recent financial crisis (especially in terms of government deficits and companies dependent on government spending). It provides a fresh focus on risk identification, evaluation and reporting and the need for constructive challenge of material assumptions, estimates and forecasts.

Going Concern and Liquidity Risk: Guidance for Directors of UK Companies – 2009

This guidance provides a timely framework to assist Directors, audit committees and

Table 2**Topical developments on corporate governance****Risk Appetite**

The FRC is currently exploring how companies are responding to the new principle in the Code relating to 'risk appetite'. An update on any new guidance is expected shortly.

Women on Boards

The latest Code recommends Board appointments should have due regard for diversity, including gender diversity. In the UK, Lord Davies' 'Women on Boards' report (Feb 2011) contains a series of recommendations to promote a higher proportion of women on Boards. An FRC announcement in this area is expected later this year.

Going Concern and Liquidity Risk Assessments

The FRC launched an inquiry into this topic in March 2011 to identify lessons for companies and auditors. The Panel of Inquiry is expected to provide its preliminary conclusions in the summer and final recommendations by the end of 2011.

Enhancements to corporate reporting and audit models

The FRC discussion paper *Effective company stewardship: Enhancing corporate reporting and audit* (Jan 2011) sets out views of how the UK's corporate reporting and audit models might be improved to deliver greater value to investors.

'A Long-Term Focus for Corporate Britain'

The UK Department for Business, Innovation and Skills (BIS) has issued a 'call for evidence' aimed at investigating issues such as the problems of short-termism, investor engagement, Directors' remuneration and the economic case for takeovers.

Combating clutter in annual reports

The Accounting Standards Board (ASB) of the FRC has published a report on 'clutter' (immaterial disclosures and explanatory information that remains unchanged from year to year). It identifies causes of clutter and provides those preparing annual reports with practical aids for reducing clutter, including a 'disclosure aid' on the corporate governance statement.

EU Green papers

After an initial paper last year on corporate governance following the recent financial crisis, the European Commission issued a second paper *The EU Corporate Governance Framework* focussed on three areas: Boards of Directors, shareholder engagement and the 'comply or explain' approach. A report on the results of this consultation, which is likely to include legislative proposals, is expected in the autumn.

finance teams in determining whether it is appropriate to adopt the going concern basis for preparing financial statements and in making balanced, proportionate and clear disclosures.

Turnbull Guidance on Internal Control - 2005

This paper sets out best practice on internal control and assists Boards in applying the section of Code dealing with risk management and internal control. It covers: responsibilities and elements of a sound system of internal control, reviewing effectiveness and the Board's statement on internal control.

TOPICAL DEVELOPMENTS ON CORPORATE GOVERNANCE

Readers with responsibility for corporate governance in their organisation will also need to take account of topical developments both from the FRC and wider afield. These are briefly summarised in Table 2.

Finally, Irish companies must also consider the impact of the ISE Annex which sets out a series of additional issues for Directors to consider (applicable for periods beginning on or after 18 December 2010). These provisions are directed at enhancing the meaningfulness of disclosures contained in the annual report, especially in the following areas:

- Explanations for divergence from the Code's provisions;
- Board balance;
- Non-executive director independence;
- Board refreshment;
- The work of key Board committees; and
- Performance evaluation.

All in all, these papers provide a broad, complex landscape for directors to negotiate.

CONCLUSION

It is beyond the scope of this article to provide detailed guidance on how the average Director should ensure he has identified all relevant requirements and that he and his Board have addressed them comprehensively. Nevertheless, a few pointers should prove useful:

- Establish the 'Universe' of obligations. Consider governing legislation and

Table 3
ISE annex requirements

Area	Responsibility
Board Composition	The size and structure of the Board and the skills, experience and expertise of Board members. It also mandates explanation where provisions of the Code have not been met.
Board Appointments	An explanation for each new appointee and of the process followed by the nomination committee in selecting and recommending the candidate.
Board Evaluation	The approach to collective Board and individual director evaluation. It also requires a statement specifying when the most recent externally facilitated performance evaluation was undertaken.
Board Re-election	Disclosure of the Board's general policy for Board renewal and details of the factors the Board took into account when determining that a director should be regarded as independent.
Audit Committee	A meaningful description of the work carried out by the audit committee during the financial year including a description of the work done by the Committee relating to the oversight of risk management on behalf of the Board.
Remuneration	A description of remuneration policy and greater disclosure of detailed remuneration

Articles of Association, applicable governance standards, existing internal policies and other rules.

- Complete a comprehensive inventory of existing policies and procedures (at Board and Executive levels).
- Draft a detailed Table of Contents for a Board Governance Manual to capture the most important requirements.
- Populate the Manual with already existing material and prepare a detailed plan to complete missing sections.
- Oversee completion of detailed work and have the resulting Manual reviewed as part of the annual review of Board effectiveness.

- Examine the assurances currently in place for Directors on compliance with governance requirements.
- Undertake awareness training, as appropriate.

Promoting governance is no longer a nice-to-have activity – legislators and regulators will insist on it. Directors should too – after all, good governance makes good business sense. ■

