



# THE COMBINED CODE ON CORPORATE GOVERNANCE



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# **THE COMBINED CODE ON CORPORATE GOVERNANCE**

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# CODE ON CORPORATE GOVERNANCE

## PREAMBLE

1. This Code supersedes and replaces the Combined Code issued by the Hampel Committee on Corporate Governance in June 1998. It derives from a review of the role and effectiveness of non-executive directors by Derek Higgs<sup>1</sup> and a review of audit committees<sup>2</sup> by a group led by Sir Robert Smith.
2. The Financial Services Authority has said that it will replace the 1998 Code that is annexed to the Listing Rules with the revised Code and will seek to make consequential Rule changes. There will be consultation on the necessary Rule changes but not further consultation on the Code provisions themselves.
3. It is intended that the new Code will apply for reporting years beginning on or after 1 November 2003.
4. The Code contains main and supporting principles and provisions. The existing Listing Rules require listed companies to make a disclosure statement in two parts in relation to the Code. In the first part of the statement, the company has to report on how it applies the principles in the Code. In future this will need to cover both main and supporting principles. The form and content of this part of the statement are not prescribed, the intention being that companies should have a free hand to explain their governance policies in the light of the principles, including any special circumstances applying to them which have led to a particular approach. In the second part of the statement the company has either to confirm that it complies with the Code's provisions or – where it does not – to provide an explanation. This 'comply or explain' approach has been in operation for over ten years and the flexibility it offers has been widely welcomed both by company boards and by investors. It is for shareholders and others to evaluate the company's statement
5. While it is expected that listed companies will comply with the Code's provisions most of the time, it is recognised that departure from the provisions of the Code may be justified in particular circumstances. Every company must review each provision carefully and give a considered explanation if it departs from the Code provisions.

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<sup>1</sup> "Review of the role and effectiveness of non-executive directors", published January 2003.

<sup>2</sup> "Audit Committees Combined Code Guidance", published January 2003.

6. Smaller listed companies, in particular those new to listing, may judge that some of the provisions are disproportionate or less relevant in their case. Some of the provisions do not apply to companies below FTSE 350. Such companies may nonetheless consider that it would be appropriate to adopt the approach in the Code and they are encouraged to consider this. Investment companies typically have a different board structure, which may affect the relevance of particular provisions.
7. Whilst recognising that directors are appointed by shareholders who are the owners of companies, it is important that those concerned with the evaluation of governance should do so with common sense in order to promote partnership and trust, based on mutual understanding. They should pay due regard to companies' individual circumstances and bear in mind in particular the size and complexity of the company and the nature of the risks and challenges it faces. Whilst shareholders have every right to challenge companies' explanations if they are unconvincing, they should not be evaluated in a mechanistic way and departures from the Code should not be automatically treated as breaches. Institutional shareholders and their agents should be careful to respond to the statements from companies in a manner that supports the 'comply or explain' principle. As the principles in Section 2 make clear, institutional shareholders should carefully consider explanations given for departure from the Code and make reasoned judgements in each case. They should put their views to the company and be prepared to enter a dialogue if they do not accept the company's position. Institutional shareholders should be prepared to put such views in writing where appropriate.
8. Nothing in this Code should be taken to override the general requirements of law to treat shareholders equally in access to information.
9. This publication includes guidance on how to comply with particular parts of the Code: first, "Internal Control: Revised Guidance for Directors on the Combined Code"<sup>3</sup>, which relates to Code provisions on internal control (C.2 and part of C.3 in the Code); and, second, "Audit Committees: Combined Code Guidance", produced by the Smith Group, which relates to the provisions on audit committees and auditors (C.3 of the Code). In both cases, the guidance suggests ways of applying the relevant Code principles and of complying with the relevant Code provisions.
10. In addition, this volume also includes suggestions for good practice from the Higgs report.

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<sup>3</sup> "Internal Control: Revised Guidance for Directors on the Combined Code", published by the Financial Reporting Council in October 2005.

11. The revised Code does not include material in the previous Code on the disclosure of directors' remuneration. This is because "The Directors' Remuneration Report Regulations 2002"<sup>4</sup> are now in force and supersede the earlier Code provisions. These require the directors of a company to prepare a remuneration report. It is important that this report is clear, transparent and understandable to shareholders.

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<sup>4</sup> The Directors' Remuneration Report Regulations 2002, S.I. no.1986.

# CODE OF BEST PRACTICE

## SECTION 1 COMPANIES

### A. DIRECTORS

#### A.1 The Board

##### Main Principle

**Every company should be headed by an effective board, which is collectively responsible for the success of the company.**

##### Supporting Principles

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.

All directors must take decisions objectively in the interests of the company.

As part of their role as members of a unitary board, non-executive directors should constructively challenge and help develop proposals on strategy. Non-executive directors should scrutinise the performance of management in meeting agreed goals and objectives and monitor the reporting of performance. They should satisfy themselves on the integrity of financial information and that financial controls and systems of risk management are robust and defensible. They are responsible for determining appropriate levels of remuneration of executive directors and have a prime role in appointing, and where necessary removing, executive directors, and in succession planning.

## Code Provisions

- A.1.1 The board should meet sufficiently regularly to discharge its duties effectively. There should be a formal schedule of matters specifically reserved for its decision. The annual report should include a statement of how the board operates, including a high level statement of which types of decisions are to be taken by the board and which are to be delegated to management.
- A.1.2 The annual report should identify the chairman, the deputy chairman (where there is one), the chief executive, the senior independent director and the chairmen and members of the nomination, audit and remuneration committees. It should also set out the number of meetings of the board and those committees and individual attendance by directors.
- A.1.3 The chairman should hold meetings with the non-executive directors without the executives present. Led by the senior independent director, the non-executive directors should meet without the chairman present at least annually to appraise the chairman's performance (as described in A.6.1) and on such other occasions as are deemed appropriate.
- A.1.4 Where directors have concerns which cannot be resolved about the running of the company or a proposed action, they should ensure that their concerns are recorded in the board minutes. On resignation, a non-executive director should provide a written statement to the chairman, for circulation to the board, if they have any such concerns.
- A.1.5 The company should arrange appropriate insurance cover in respect of legal action against its directors.

## A.2 Chairman and chief executive

### Main Principle

**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.**

### Supporting Principle

The chairman is responsible for leadership of the board, ensuring its effectiveness on all aspects of its role and setting its agenda. The chairman is also responsible for ensuring that the directors receive accurate, timely and clear information. The chairman should ensure effective communication with shareholders. The chairman should also facilitate the effective contribution of non-executive directors in particular

and ensure constructive relations between executive and non-executive directors.

## Code Provisions

A.2.1 The roles of chairman and chief executive should not be exercised by the same individual. The division of responsibilities between the chairman and chief executive should be clearly established, set out in writing and agreed by the board.

A.2.2<sup>5</sup> The chairman should on appointment meet the independence criteria set out in A.3.1 below. A chief executive should not go on to be chairman of the same company. If exceptionally a board decides that a chief executive should become chairman, the board should consult major shareholders in advance and should set out its reasons to shareholders at the time of the appointment and in the next annual report.

## A.3 Board balance and independence

### Main Principle

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

### Supporting Principles

The board should not be so large as to be unwieldy. The board should be of sufficient size that the balance of skills and experience is appropriate for the requirements of the business and that changes to the board's composition can be managed without undue disruption.

To ensure that power and information are not concentrated in one or two individuals, there should be a strong presence on the board of both executive and non-executive directors.

The value of ensuring that committee membership is refreshed and that undue reliance is not placed on particular individuals should be taken into account in deciding chairmanship and membership of committees.

No one other than the committee chairman and members is entitled to be present at a meeting of the nomination, audit or remuneration committee, but others may attend at the invitation of the committee.

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<sup>5</sup> Compliance or otherwise with this provision need only be reported for the year in which the appointment is made.

**Code provisions**

A.3.1 The board should identify in the annual report each non-executive director it considers to be independent<sup>6</sup>. The board should determine whether the director is independent in character and judgement and whether there are relationships or circumstances which are likely to affect, or could appear to affect, the director's judgement. The board should state its reasons if it determines that a director is independent notwithstanding the existence of relationships or circumstances which may appear relevant to its determination, including if the director:

- has been an employee of the company or group within the last five years;
- has, or has had within the last three years, a material business relationship with the company either directly, or as a partner, shareholder, director or senior employee of a body that has such a relationship with the company;
- has received or receives additional remuneration from the company apart from a director's fee, participates in the company's share option or a performance-related pay scheme, or is a member of the company's pension scheme;
- has close family ties with any of the company's advisers, directors or senior employees;
- holds cross-directorships or has significant links with other directors through involvement in other companies or bodies;
- represents a significant shareholder; or
- has served on the board for more than nine years from the date of their first election.

A.3.2 Except for smaller companies<sup>7</sup>, at least half the board, excluding the chairman, should comprise non-executive directors determined by the board to be independent. A smaller company should have at least two independent non-executive directors.

A.3.3 The board should appoint one of the independent non-executive directors to be the senior independent director. The senior independent director should be available to shareholders if they have concerns which contact through the normal channels of chairman, chief executive or finance director has failed to resolve or for which such contact is inappropriate.

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<sup>6</sup> A.2.2 states that the chairman should, on appointment, meet the independence criteria set out in this provision, but thereafter the test of independence is not appropriate in relation to the chairman.

<sup>7</sup> A smaller company is one that is below the FTSE 350 throughout the year immediately prior to the reporting year.

## **A.4 Appointments to the Board**

### **Main Principle**

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

### **Supporting Principles**

Appointments to the board should be made on merit and against objective criteria. Care should be taken to ensure that appointees have enough time available to devote to the job. This is particularly important in the case of chairmanships.

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

### **Code Provisions**

- A.4.1 There should be a nomination committee which should lead the process for board appointments and make recommendations to the board. A majority of members of the nomination committee should be independent non-executive directors. The chairman or an independent non-executive director should chair the committee, but the chairman should not chair the nomination committee when it is dealing with the appointment of a successor to the chairmanship. The nomination committee should make available<sup>8</sup> its terms of reference, explaining its role and the authority delegated to it by the board.
- A.4.2 The nomination committee should evaluate the balance of skills, knowledge and experience on the board and, in the light of this evaluation, prepare a description of the role and capabilities required for a particular appointment.
- A.4.3 For the appointment of a chairman, the nomination committee should prepare a job specification, including an assessment of the time commitment expected, recognising the need for availability in the event of crises. A chairman's other significant commitments should be disclosed to the board before appointment and included in the annual report. Changes to such commitments should be reported to the board as they arise, and included in the next annual report. No individual should be appointed to a second chairmanship of a FTSE 100 company<sup>9</sup>.

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<sup>8</sup> The requirement to make the information available would be met by making it available on request and by including the information on the company's website.

<sup>9</sup> Compliance or otherwise with this provision need only be reported for the year in which the appointment is made.

- A.4.4 The terms and conditions of appointment of non-executive directors should be made available for inspection<sup>10</sup>. The letter of appointment should set out the expected time commitment. Non-executive directors should undertake that they will have sufficient time to meet what is expected of them. Their other significant commitments should be disclosed to the board before appointment, with a broad indication of the time involved and the board should be informed of subsequent changes.
- A.4.5 The board should not agree to a full time executive director taking on more than one non-executive directorship in a FTSE 100 company nor the chairmanship of such a company.
- A.4.6 A separate section of the annual report should describe the work of the nomination committee, including the process it has used in relation to board appointments. An explanation should be given if neither an external search consultancy nor open advertising has been used in the appointment of a chairman or a non-executive director.

## **A.5 Information and professional development**

### **Main Principle**

**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.**

### **Supporting Principles**

The chairman is responsible for ensuring that the directors receive accurate, timely and clear information. Management has an obligation to provide such information but directors should seek clarification or amplification where necessary.

The chairman should ensure that the directors continually update their skills and the knowledge and familiarity with the company required to fulfil their role both on the board and on board committees. The company should provide the necessary resources for developing and updating its directors' knowledge and capabilities.

Under the direction of the chairman, the company secretary's responsibilities include ensuring good information flows within the board

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<sup>10</sup> The terms and conditions of appointment of non-executive directors should be made available for inspection by any person at the company's registered office during normal business hours and at the AGM (for 15 minutes prior to the meeting and during the meeting).

and its committees and between senior management and non-executive directors, as well as facilitating induction and assisting with professional development as required.

The company secretary should be responsible for advising the board through the chairman on all governance matters.

## **Code Provisions**

- A.5.1 The chairman should ensure that new directors receive a full, formal and tailored induction on joining the board. As part of this, the company should offer to major shareholders the opportunity to meet a new non-executive director.
- A.5.2 The board should ensure that directors, especially non-executive directors, have access to independent professional advice at the company's expense where they judge it necessary to discharge their responsibilities as directors. Committees should be provided with sufficient resources to undertake their duties.
- A.5.3 All directors should have access to the advice and services of the company secretary, who is responsible to the board for ensuring that board procedures are complied with. Both the appointment and removal of the company secretary should be a matter for the board as a whole.

## **A.6 Performance evaluation**

### **Main Principle**

**The board should undertake a formal and rigorous annual evaluation of its own performance and that of its committees and individual directors.**

### **Supporting Principle**

Individual evaluation should aim to show whether each director continues to contribute effectively and to demonstrate commitment to the role (including commitment of time for board and committee meetings and any other duties). The chairman should act on the results of the performance evaluation by recognising the strengths and addressing the weaknesses of the board and, where appropriate, proposing new members be appointed to the board or seeking the resignation of directors.

## Code Provision

- A.6.1 The board should state in the annual report how performance evaluation of the board, its committees and its individual directors has been conducted. The non-executive directors, led by the senior independent director, should be responsible for performance evaluation of the chairman, taking into account the views of executive directors.

## A.7 Re-election

### Main Principle

**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.**

### Code Provisions

- A.7.1 All directors should be subject to election by shareholders at the first annual general meeting after their appointment, and to re-election thereafter at intervals of no more than three years. The names of directors submitted for election or re-election should be accompanied by sufficient biographical details and any other relevant information to enable shareholders to take an informed decision on their election.
- A.7.2 Non-executive directors should be appointed for specified terms subject to re-election and to Companies Acts provisions relating to the removal of a director. The board should set out to shareholders in the papers accompanying a resolution to elect a non-executive director why they believe an individual should be elected. The chairman should confirm to shareholders when proposing re-election that, following formal performance evaluation, the individual's performance continues to be effective and to demonstrate commitment to the role. Any term beyond six years (e.g. two three-year terms) for a non-executive director should be subject to particularly rigorous review, and should take into account the need for progressive refreshing of the board. Non-executive directors may serve longer than nine years (e.g. three three-year terms), subject to annual re-election. Serving more than nine years could be relevant to the determination of a non-executive director's independence (as set out in provision A.3.1).

## **B. REMUNERATION**

### **B.1 The Level and Make-up of Remuneration<sup>11</sup>**

#### **Main Principles**

**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.**

#### **Supporting Principle**

The remuneration committee should judge where to position their company relative to other companies. But they should use such comparisons with caution, in view of the risk of an upward ratchet of remuneration levels with no corresponding improvement in performance. They should also be sensitive to pay and employment conditions elsewhere in the group, especially when determining annual salary increases.

#### **Code Provisions**

##### **Remuneration policy**

- B.1.1** The performance-related elements of remuneration should form a significant proportion of the total remuneration package of executive directors and should be designed to align their interests with those of shareholders and to give these directors keen incentives to perform at the highest levels. In designing schemes of performance-related remuneration, the remuneration committee should follow the provisions in Schedule A to this Code.
- B.1.2** Executive share options should not be offered at a discount save as permitted by the relevant provisions of the Listing Rules.
- B.1.3** Levels of remuneration for non-executive directors should reflect the time commitment and responsibilities of the role. Remuneration for non-executive directors should not include share options. If, exceptionally, options are granted, shareholder approval should be sought in advance and any shares acquired by exercise of the options should be held until at

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<sup>11</sup> Views have been sought by the Department of Trade and Industry by 30 September 2003 on whether, and if so how, further measures are required to enable shareholders to ensure that compensation reflects performance when directors' contracts are terminated: See "Rewards for Failure": Directors' Remuneration – Contracts, performance and severance, June 2003.

least one year after the non-executive director leaves the board. Holding of share options could be relevant to the determination of a non-executive director's independence (as set out in provision A.3.1).

- B.1.4 Where a company releases an executive director to serve as a non-executive director elsewhere, the remuneration report<sup>12</sup> should include a statement as to whether or not the director will retain such earnings and, if so, what the remuneration is.

## **Service Contracts and Compensation**

- B.1.5 The remuneration committee should carefully consider what compensation commitments (including pension contributions and all other elements) their directors' terms of appointment would entail in the event of early termination. The aim should be to avoid rewarding poor performance. They should take a robust line on reducing compensation to reflect departing directors' obligations to mitigate loss.

- B.1.6 Notice or contract periods should be set at one year or less. If it is necessary to offer longer notice or contract periods to new directors recruited from outside, such periods should reduce to one year or less after the initial period.

## **B.2 Procedure**

### **Main Principle**

**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.**

### **Supporting Principles**

The remuneration committee should consult the chairman and/or chief executive about their proposals relating to the remuneration of other executive directors. The remuneration committee should also be responsible for appointing any consultants in respect of executive director remuneration. Where executive directors or senior management are involved in advising or supporting the remuneration committee, care should be taken to recognise and avoid conflicts of interest.

The chairman of the board should ensure that the company maintains contact as required with its principal shareholders about remuneration in the same way as for other matters.

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<sup>12</sup> As required under the Directors' Remuneration Report Regulations.

**Code Provisions**

- B.2.1 The board should establish a remuneration committee of at least three, or in the case of smaller companies<sup>13</sup> two, members, who should all be independent non-executive directors. The remuneration committee should make available<sup>14</sup> its terms of reference, explaining its role and the authority delegated to it by the board. Where remuneration consultants are appointed, a statement should be made available<sup>15</sup> of whether they have any other connection with the company.
- B.2.2 The remuneration committee should have delegated responsibility for setting remuneration for all executive directors and the chairman, including pension rights and any compensation payments. The committee should also recommend and monitor the level and structure of remuneration for senior management. The definition of 'senior management' for this purpose should be determined by the board but should normally include the first layer of management below board level.
- B.2.3 The board itself or, where required by the Articles of Association, the shareholders should determine the remuneration of the non-executive directors within the limits set in the Articles of Association. Where permitted by the Articles, the board may however delegate this responsibility to a committee, which might include the chief executive.
- B.2.4 Shareholders should be invited specifically to approve all new long-term incentive schemes (as defined in the Listing Rules) and significant changes to existing schemes, save in the circumstances permitted by the Listing Rules.

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<sup>13</sup> See footnote 7

<sup>14</sup> See footnote 8

<sup>15</sup> See footnote 8

## **C. ACCOUNTABILITY AND AUDIT**

### **C.1 Financial Reporting**

#### **Main Principle**

**The board should present a balanced and understandable assessment of the company's position and prospects.**

#### **Supporting Principle**

The board's responsibility to present a balanced and understandable assessment extends to interim and other price-sensitive public reports and reports to regulators as well as to information required to be presented by statutory requirements.

#### **Code Provisions**

C.1.1 The directors should explain in the annual report their responsibility for preparing the accounts and there should be a statement by the auditors about their reporting responsibilities.

C.1.2 The directors should report that the business is a going concern, with supporting assumptions or qualifications as necessary.

### **C.2 Internal Control<sup>16</sup>**

#### **Main Principle**

**The board should maintain a sound system of internal control to safeguard shareholders' investment and the company's assets.**

#### **Code Provision**

C.2.1 The board should, at least annually, conduct a review of the effectiveness of the group's system of internal controls and should report to shareholders that they have done so. The review should cover all material controls, including financial, operational and compliance controls and risk management systems.

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<sup>16</sup> The Turnbull guidance suggests means of applying this part of the Code.

### C.3 Audit Committee and Auditors<sup>17</sup>

#### Main Principle

**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.**

#### Code provisions

C.3.1 The board should establish an audit committee of at least three, or in the case of smaller companies<sup>18</sup> 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.

C.3.2 The main role and responsibilities of the audit committee should be set out in written terms of reference and should include:

- to monitor the integrity of the financial statements of the company, and any formal announcements relating to the company's financial performance, reviewing significant financial reporting judgements contained in them;
- to review the company's internal financial controls and, unless expressly addressed by a separate board risk committee composed of independent directors, or by the board itself, to review the company's internal control and risk management systems;
- to monitor and review the effectiveness of the company's internal audit function;
- to make recommendations to the board, for it to put to the shareholders for their approval in general meeting, in relation to the appointment, re-appointment and removal of the external auditor and to approve the remuneration and terms of engagement of the external auditor;
- to review and monitor the external auditor's independence and objectivity and the effectiveness of the audit process, taking into consideration relevant UK professional and regulatory requirements;
- to develop and implement policy on the engagement of the external auditor to supply non-audit services, taking into account relevant ethical guidance regarding the provision of non-audit services by the external audit firm; and to report to the board, identifying any

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<sup>17</sup> The Smith guidance suggests means of applying this part of the Code.

<sup>18</sup> See footnote 7

matters in respect of which it considers that action or improvement is needed and making recommendations as to the steps to be taken.

- C.3.3 The terms of reference of the audit committee, including its role and the authority delegated to it by the board, should be made available.<sup>19</sup> A separate section of the annual report should describe the work of the committee in discharging those responsibilities.
- C.3.4 The audit committee should review arrangements by which staff of the company may, in confidence, raise concerns about possible improprieties in matters of financial reporting or other matters. The audit committee's objective should be to ensure that arrangements are in place for the proportionate and independent investigation of such matters and for appropriate follow-up action.
- C.3.5 The audit committee should monitor and review the effectiveness of the internal audit activities. Where there is no internal audit function, the audit committee should consider annually whether there is a need for an internal audit function and make a recommendation to the board, and the reasons for the absence of such a function should be explained in the relevant section of the annual report.
- C.3.6 The audit committee should have primary responsibility for making a recommendation on the appointment, reappointment and removal of the external auditors. If the board does not accept the audit committee's recommendation, it should include in the annual report, and in any papers recommending appointment or re-appointment, a statement from the audit committee explaining the recommendation and should set out reasons why the board has taken a different position.
- C.3.7 The annual report should explain to shareholders how, if the auditor provides non-audit services, auditor objectivity and independence is safeguarded.

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<sup>19</sup> See footnote 8.

## **D. RELATIONS WITH SHAREHOLDERS**

### **D.1 Dialogue with Institutional Shareholders**

#### **Main Principle**

**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.<sup>20</sup>**

#### **Supporting Principles**

Whilst recognising that most shareholder contact is with the chief executive and finance director, the chairman (and the senior independent director and other directors as appropriate) should maintain sufficient contact with major shareholders to understand their issues and concerns.

The board should keep in touch with shareholder opinion in whatever ways are most practical and efficient.

#### **Code Provisions**

D.1.1 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. Non-executive directors should be offered the opportunity to attend meetings with major shareholders and should expect to attend them if requested by major shareholders. The senior independent director should attend sufficient meetings with a range of major shareholders to listen to their views in order to help develop a balanced understanding of the issues and concerns of major shareholders.

D.1.2 The board should state in the annual report the steps they have taken to ensure that the members of the board, and in particular the non-executive directors, develop an understanding of the views of major shareholders about their company, for example through direct face-to-face contact, analysts' or brokers' briefings and surveys of shareholder opinion.

### **D.2 Constructive Use of the AGM**

#### **Main Principle**

**The board should use the AGM to communicate with investors and to encourage their participation.**

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<sup>20</sup> Nothing in these principles or provisions should be taken to override the general requirements of law to treat shareholders equally in access to information.

## Code Provisions

- D.2.1 The company should count all proxy votes and, except where a poll is called, should indicate the level of proxies lodged on each resolution, and the balance for and against the resolution and the number of abstentions, after it has been dealt with on a show of hands. The company should ensure that votes cast are properly received and recorded.
- D.2.2 The company should propose a separate resolution at the AGM on each substantially separate issue and should in particular propose a resolution at the AGM relating to the report and accounts.
- D.2.3 The chairman should arrange for the chairmen of the audit, remuneration and nomination committees to be available to answer questions at the AGM and for all directors to attend.
- D.2.4 The company should arrange for the Notice of the AGM and related papers to be sent to shareholders at least 20 working days before the meeting.

## SECTION 2 INSTITUTIONAL SHAREHOLDERS

### E. INSTITUTIONAL SHAREHOLDERS<sup>21</sup>

#### E.1 Dialogue with companies

##### Main Principle

**Institutional shareholders should enter into a dialogue with companies based on the mutual understanding of objectives.**

##### Supporting Principles

Institutional shareholders should apply the principles set out in the Institutional Shareholders' Committee's "The Responsibilities of Institutional Shareholders and Agents – Statement of Principles"<sup>22</sup>, which should be reflected in fund manager contracts.

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<sup>21</sup> Agents such as investment managers, or voting services, are frequently appointed by institutional shareholders to act on their behalf and these principles should accordingly be read as applying where appropriate to the agents of institutional shareholders.

<sup>22</sup> Available at website: [www.investmentuk.org.uk/press/2002/20021021-01.pdf](http://www.investmentuk.org.uk/press/2002/20021021-01.pdf)

## **E.2 Evaluation of Governance Disclosures**

### **Main Principle**

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.

### **Supporting Principle**

Institutional shareholders should consider carefully explanations given for departure from this Code and make reasoned judgements in each case. They should give an explanation to the company, in writing where appropriate, and be prepared to enter a dialogue if they do not accept the company's position. They should avoid a box-ticking approach to assessing a company's corporate governance. They should bear in mind in particular the size and complexity of the company and the nature of the risks and challenges it faces.

## **E.3 Shareholder Voting**

### **Main Principle**

**Institutional shareholders have a responsibility to make considered use of their votes.**

### **Supporting Principles**

Institutional shareholders should take steps to ensure their voting intentions are being translated into practice.

Institutional shareholders should, on request, make available to their clients information on the proportion of resolutions on which votes were cast and non-discretionary proxies lodged.

Major shareholders should attend AGMs where appropriate and practicable. Companies and registrars should facilitate this.

**Schedule A: Provisions on the design of performance related remuneration**

1. The remuneration committee should consider whether the directors should be eligible for annual bonuses. If so, performance conditions should be relevant, stretching and designed to enhance shareholder value. Upper limits should be set and disclosed. There may be a case for part payment in shares to be held for a significant period.
2. The remuneration committee should consider whether the directors should be eligible for benefits under long-term incentive schemes. Traditional share option schemes should be weighed against other kinds of long-term incentive scheme. In normal circumstances, 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.
3. Any new long-term incentive schemes which are proposed should be approved by shareholders and should preferably replace any existing schemes or at least form part of a well considered overall plan, incorporating existing schemes. The total rewards potentially available should not be excessive.
4. Payouts or grants under all incentive schemes, including new grants under existing share option schemes, should be subject to challenging performance criteria reflecting the company's objectives. Consideration should be given to criteria which reflect the company's performance relative to a group of comparator companies in some key variables such as total shareholder return.
5. Grants under executive share option and other long-term incentive schemes should normally be phased rather than awarded in one large block.
6. In general, only basic salary should be pensionable.
7. The remuneration committee should consider the pension consequences and associated costs to the company of basic salary increases and any other changes in pensionable remuneration, especially for directors close to retirement.

## **Schedule B:      Guidance on liability of non-executive directors: care, skill and diligence**

1. Although non-executive directors and executive directors have as board members the same legal duties and objectives, the time devoted to the company's affairs is likely to be significantly less for a non-executive director than for an executive director and the detailed knowledge and experience of a company's affairs that could reasonably be expected of a non-executive director will generally be less than for an executive director. These matters may be relevant in assessing the knowledge, skill and experience which may reasonably be expected of a non-executive director and therefore the care, skill and diligence that a non-executive director may be expected to exercise.
2. In this context, the following elements of the Code may also be particularly relevant.
  - (i) In order to enable directors to fulfil their duties, the Code states that:
    - The letter of appointment of the director should set out the expected time commitment (Code provision A.4.4); and
    - 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. The chairman is responsible for ensuring that the directors are provided by management with accurate, timely and clear information. (Code principles A.5).
  - (ii) Non-executive directors should themselves:
    - Undertake appropriate induction and regularly update and refresh their skills, knowledge and familiarity with the company (Code principle A.5 and provision A.5.1)
    - Seek appropriate clarification or amplification of information and, where necessary, take and follow appropriate professional advice. (Code principle A.5 and provision A.5.2)
    - Where they have concerns about the running of the company or a proposed action, ensure that these are addressed by the board and, to the extent that they are not resolved, ensure that they are recorded in the board minutes (Code provision A.1.4).
    - Give a statement to the board if they have such unresolved concerns on resignation (Code provision A.1.4)
3. It is up to each non-executive director to reach a view as to what is necessary in particular circumstances to comply with the duty of care, skill and diligence they owe as a director to the company. In considering whether or not a person is in breach of that duty, a court would take into account all relevant circumstances. These may include having regard to the above where relevant to the issue of liability of a non-executive director.

## **Schedule C: Disclosure of corporate governance arrangements**

The Listing Rules require a statement to be included in the annual report relating to compliance with the Code, as described in the preamble.

For ease of reference, the specific requirements in the Code for disclosure are set out below:

The annual report should record:

- a statement of how the board operates, including a high level statement of which types of decisions are to be taken by the board and which are to be delegated to management (A.1.1);
- the names of the chairman, the deputy chairman (where there is one), the chief executive, the senior independent director and the chairmen and members of the nomination, audit and remuneration committees (A.1.2);
- the number of meetings of the board and those committees and individual attendance by directors (A.1.2);
- the names of the non-executive directors whom the board determines to be independent, with reasons where necessary (A.3.1);
- the other significant commitments of the chairman and any changes to them during the year (A.4.3);
- how performance evaluation of the board, its committees and its directors has been conducted (A.6.1);
- the steps the board has taken to ensure that members of the board, and in particular the non-executive directors, develop an understanding of the views of major shareholders about their company (D.1.2).

The report should also include:

- a separate section describing the work of the nomination committee, including the process it has used in relation to board appointments and an explanation if neither external search consultancy nor open advertising has been used in the appointment of a chairman or a non-executive director (A.4.6);
- a description of the work of the remuneration committee as required under the Directors' Remuneration Reporting Regulations 2002, and including, where an executive director serves as a non-executive director elsewhere, whether or not the director will retain such earnings and, if so, what the remuneration is (B.1.4);
- an explanation from the directors of their responsibility for preparing the accounts and a statement by the auditors about their reporting responsibilities (C.1.1);

- a statement from the directors that the business is a going concern, with supporting assumptions or qualifications as necessary (C.1.2);
- a report that the board has conducted a review of the effectiveness of the group's system of internal controls (C.2.1);
- a separate section describing the work of the audit committee in discharging its responsibilities (C.3.3);
- where there is no internal audit function, the reasons for the absence of such a function (C.3.5);
- where the board does not accept the audit committee's recommendation on the appointment, reappointment or removal of an external auditor, a statement from the audit committee explaining the recommendation and the reasons why the board has taken a different position (C.3.6); and
- an explanation of how, if the auditor provides non-audit services, auditor objectivity and independence is safeguarded (C.3.7).

**The following information should be made available (which may be met by making it available on request and placing the information available on the company's website):**

- the terms of reference of the nomination, remuneration and audit committees, explaining their role and the authority delegated to them by the board (A.4.1, B.2.1 and C.3.3);
- the terms and conditions of appointment of non-executive directors (A.4.4) (see footnote 10 on page 9); and
- where remuneration consultants are appointed, a statement of whether they have any other connection with the company (B.2.1).

**The board should set out to shareholders in the papers accompanying a resolution to elect or re-elect:**

- sufficient biographical details to enable shareholders to take an informed decision on their election or re-election (A.7.1).
- why they believe an individual should be elected to a non-executive role (A.7.2).
- on re-election of a non-executive director, confirmation from the chairman that, following formal performance evaluation, the individual's performance continues to be effective and to demonstrate commitment to the role, including commitment of time for board and committee meetings and any other duties (A.7.2).

**The board should set out to shareholders in the papers recommending appointment or reappointment of an external auditor:**

- if the board does not accept the audit committee's recommendation, a statement from the audit committee explaining the recommendation and from the board setting out reasons why they have taken a different position (C.3.6).



# GUIDANCE ON INTERNAL CONTROL (The Turnbull Guidance)

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## PREFACE

*Internal Control: Guidance for Directors on the Combined Code* (The Turnbull guidance) was first issued in 1999.

In 2004, the Financial Reporting Council established the Turnbull Review Group to consider the impact of the guidance and the related disclosures and to determine whether the guidance needed to be updated.

In reviewing the impact of the guidance, our consultations revealed that it has very successfully gone a long way to meeting its original objectives. Boards and investors alike indicated that the guidance has contributed to a marked improvement in the overall standard of risk management and internal control since 1999.

Notably, the evidence gathered by the Review Group demonstrated that respondents considered that the substantial improvements in internal control instigated by application of the Turnbull guidance have been achieved without the need for detailed prescription as to how to implement the guidance. The principles-based approach has required boards to think seriously about control issues and enabled them to apply the principles in a way that appropriately dealt with the circumstances of their business. The evidence also supported the proposition that the companies which have derived most benefit from application of the guidance were those whose boards saw embedded risk management and internal control as an integral part of running the business.

Accordingly, the Review Group strongly endorsed retention of the flexible, principles-based approach of the original guidance and has made only a small number of changes.

This however does not mean that there is nothing new for boards to do or that some companies could not make more effective use of the guidance. Establishing an effective system of internal control is not a one-off exercise. No such system remains effective unless it develops to take account of new and emerging risks, control failures, market expectations or changes in the company's circumstances or business objectives. The Review Group reiterates the view of the vast majority of respondents in emphasising the importance of regular and systematic assessment of the risks facing the business and the value of embedding risk management and internal control systems within business processes. It is the board's responsibility to make sure this happens.

Boards should review whether they can make more of the communication opportunity of the internal control statement in the annual report. Investors consider the board's attitude towards risk management and internal control to be an important factor when making investment decisions about a company. Taken together with the Operating and Financial Review, the internal control statement provides an opportunity for the board to help shareholders understand the risk

and control issues facing the company, and to explain how the company maintains a framework of internal controls to address these issues and how the board has reviewed the effectiveness of that framework.

It is in this spirit that directors need to exercise their responsibility to review on a continuing basis their application of the revised guidance.

Turnbull Review Group  
October 2005

## INTRODUCTION

### The importance of internal control and risk management

- 1 A company's system of internal control has a key role in the management of risks that are significant to the fulfilment of its business objectives. A sound system of internal control contributes to safeguarding the shareholders' investment and the company's assets.
- 2 Internal control (as referred to in paragraph 19) facilitates the effectiveness and efficiency of operations, helps ensure the reliability of internal and external reporting and assists compliance with laws and regulations.
- 3 Effective financial controls, including the maintenance of proper accounting records, are an important element of internal control. They help ensure that the company is not unnecessarily exposed to avoidable financial risks and that financial information used within the business and for publication is reliable. They also contribute to the safeguarding of assets, including the prevention and detection of fraud.
- 4 A company's objectives, its internal organisation and the environment in which it operates are continually evolving and, as a result, the risks it faces are continually changing. A sound system of internal control therefore depends on a thorough and regular evaluation of the nature and extent of the risks to which the company is exposed. Since profits are, in part, the reward for successful risk-taking in business, the purpose of internal control is to help manage and control risk appropriately rather than to eliminate it.

### Objectives of the guidance

- 5 This guidance is intended to:
  - reflect sound business practice whereby internal control is embedded in the business processes by which a company pursues its objectives;
  - remain relevant over time in the continually evolving business environment; and
  - enable each company to apply it in a manner which takes account of its particular circumstances.

The guidance requires directors to exercise judgement in reviewing how the company has implemented the requirements of the Combined Code relating to internal control and reporting to shareholders thereon.

- 6 The guidance is based on the adoption by a company's board of a risk-based approach to establishing a sound system of internal control and reviewing its effectiveness. This should be incorporated by the company within its normal management and governance processes. It should not be treated as a separate exercise undertaken to meet regulatory requirements.

### Internal control requirements of the Combined Code

- 7 Principle C.2 of the Code states that 'The board should maintain a sound system of internal control to safeguard shareholders' investment and the company's assets'.
- 8 Provision C.2.1 states that 'The directors should, at least annually, conduct a review of the effectiveness of the group's system of internal control and should report to shareholders that they have done so. The review should cover all material controls, including financial, operational and compliance controls and risk management systems'.
- 9 Paragraph 9.8.6 of the UK Listing Authority's Listing Rules states that in the case of a listed company incorporated in the United Kingdom, the following items must be included in its annual report and accounts:
- a statement of how the listed company has applied the principles set out in Section 1 of the Combined Code, in a manner that would enable shareholders to evaluate how the principles have been applied;
  - a statement as to whether the listed company has:
    - complied throughout the accounting period with all relevant provisions set out in Section 1 of the Combined Code; or
    - not complied throughout the accounting period with all relevant provisions set out in Section 1 of the Combined Code and if so, setting out:
      - (i) those provisions, if any, it has not complied with;
      - (ii) in the case of provisions whose requirements are of a continuing nature, the period within which, if any, it did not comply with some or all of those provisions; and
      - (iii) the company's reasons for non-compliance.
- 10 The Preamble to the Code makes it clear that there is no prescribed form or content for the statement setting out how the various principles in the Code have been applied. The intention is that companies should have a

free hand to explain their governance policies in the light of the principles, including any special circumstances which have led to them adopting a particular approach.

- 11 The guidance in this document applies for accounting periods beginning on or after 1 January 2006, and should be followed by boards of listed companies in:
- assessing how the company has applied Code Principle C.2;
  - implementing the requirements of Code Provision C.2.1; and
  - reporting on these matters to shareholders in the annual report and accounts.
- 12 For the purposes of this guidance, internal controls considered by the board should include all types of controls including those of an operational and compliance nature, as well as internal financial controls.

### Groups of companies

- 13 Throughout this guidance, where reference is made to 'company' it should be taken, where applicable, as referring to the group of which the reporting company is the parent company. For groups of companies, the review of effectiveness of internal control and the report to the shareholders should be from the perspective of the group as a whole.

### The Appendix

- 14 The Appendix to this document contains questions which boards may wish to consider in applying this guidance.

## MAINTAINING A SOUND SYSTEM OF INTERNAL CONTROL

### Responsibilities

- 15 The board of directors is responsible for the company's system of internal control. It should set appropriate policies on internal control and seek regular assurance that will enable it to satisfy itself that the system is functioning effectively. The board must further ensure that the system of internal control is effective in managing those risks in the manner which it has approved.
- 16 In determining its policies with regard to internal control, and thereby assessing what constitutes a sound system of internal control in the particular circumstances of the company, the board's deliberations should include consideration of the following factors:
  - the nature and extent of the risks facing the company;
  - the extent and categories of risk which it regards as acceptable for the company to bear;
  - the likelihood of the risks concerned materialising;
  - the company's ability to reduce the incidence and impact on the business of risks that do materialise; and
  - the costs of operating particular controls relative to the benefit thereby obtained in managing the related risks.
- 17 It is the role of management to implement board policies on risk and control. In fulfilling its responsibilities management should identify and evaluate the risks faced by the company for consideration by the board and design, operate and monitor a suitable system of internal control which implements the policies adopted by the board.
- 18 All employees have some responsibility for internal control as part of their accountability for achieving objectives. They, collectively, should have the necessary knowledge, skills, information, and authority to establish, operate and monitor the system of internal control. This will require an understanding of the company, its objectives, the industries and markets in which it operates, and the risks it faces.

### Elements of a sound system of internal control

- 19 An internal control system encompasses the policies, processes, tasks, behaviours and other aspects of a company that, taken together:

- facilitate its effective and efficient operation by enabling it to respond appropriately to significant business, operational, financial, compliance and other risks to achieving the company's objectives. This includes the safeguarding of assets from inappropriate use or from loss and fraud and ensuring that liabilities are identified and managed;
  - help ensure the quality of internal and external reporting. This requires the maintenance of proper records and processes that generate a flow of timely, relevant and reliable information from within and outside the organisation;
  - help ensure compliance with applicable laws and regulations, and also with internal policies with respect to the conduct of business.
- 20 A company's system of internal control will reflect its control environment which encompasses its organisational structure. The system will include:
- control activities;
  - information and communications processes; and
  - processes for monitoring the continuing effectiveness of the system of internal control.
- 21 The system of internal control should:
- be embedded in the operations of the company and form part of its culture;
  - be capable of responding quickly to evolving risks to the business arising from factors within the company and to changes in the business environment; and
  - include procedures for reporting immediately to appropriate levels of management any significant control failings or weaknesses that are identified together with details of corrective action being undertaken.
- 22 A sound system of internal control reduces, but cannot eliminate, the possibility of poor judgement in decision-making; human error; control processes being deliberately circumvented by employees and others; management overriding controls; and the occurrence of unforeseeable circumstances.
- 23 A sound system of internal control therefore provides reasonable, but not absolute, assurance that a company will not be hindered in achieving its business objectives, or in the orderly and legitimate conduct of its business, by circumstances which may reasonably be foreseen. A system of internal control cannot, however, provide protection with certainty against a company failing to meet its business objectives or all material errors, losses, fraud, or breaches of laws or regulations.

## REVIEWING THE EFFECTIVENESS OF INTERNAL CONTROL

### Responsibilities

- 24     Reviewing the effectiveness of internal control is an essential part of the board's responsibilities. The board will need to form its own view on effectiveness based on the information and assurances provided to it, exercising the standard of care generally applicable to directors in the exercise of their duties. Management is accountable to the board for monitoring the system of internal control and for providing assurance to the board that it has done so.
- 25     The role of board committees in the review process, including that of the audit committee, is for the board to decide and will depend upon factors such as the size and composition of the board; the scale, diversity and complexity of the company's operations; and the nature of the significant risks that the company faces. To the extent that designated board committees carry out, on behalf of the board, tasks that are attributed in this guidance document to the board, the results of the relevant committees' work should be reported to, and considered by, the board. The board takes responsibility for the disclosures on internal control in the annual report and accounts.

### The process for reviewing effectiveness

- 26     Effective monitoring on a continuous basis is an essential component of a sound system of internal control. The board cannot, however, rely solely on the embedded monitoring processes within the company to discharge its responsibilities. It should regularly receive and review reports on internal control. In addition, the board should undertake an annual assessment for the purposes of making its public statement on internal control to ensure that it has considered all significant aspects of internal control for the company for the year under review and up to the date of approval of the annual report and accounts.
- 27     The board should define the process to be adopted for its review of the effectiveness of internal control. This should encompass both the scope and frequency of the reports it receives and reviews during the year, and also the process for its annual assessment, such that it will be provided with sound, appropriately documented, support for its statement on internal control in the company's annual report and accounts.
- 28     The reports from management to the board should, in relation to the areas covered by them, provide a balanced assessment of the significant risks and the effectiveness of the system of internal control in managing those risks. Any significant control failings or weaknesses identified should be

discussed in the reports, including the impact that they have had, or may have, on the company and the actions being taken to rectify them. It is essential that there be openness of communication by management with the board on matters relating to risk and control.

29 When reviewing reports during the year, the board should:

- consider what are the significant risks and assess how they have been identified, evaluated and managed;
- assess the effectiveness of the related system of internal control in managing the significant risks, having regard in particular to any significant failings or weaknesses in internal control that have been reported;
- consider whether necessary actions are being taken promptly to remedy any significant failings or weaknesses; and
- consider whether the findings indicate a need for more extensive monitoring of the system of internal control.

30 Additionally, the board should undertake an annual assessment for the purpose of making its public statement on internal control. The assessment should consider issues dealt with in reports reviewed by it during the year together with any additional information necessary to ensure that the board has taken account of all significant aspects of internal control for the company for the year under review and up to the date of approval of the annual report and accounts.

31 The board's annual assessment should, in particular, consider:

- the changes since the last annual assessment in the nature and extent of significant risks, and the company's ability to respond to changes in its business and the external environment;
- the scope and quality of management's ongoing monitoring of risks and of the system of internal control, and, where applicable, the work of its internal audit function and other providers of assurance;
- the extent and frequency of the communication of the results of the monitoring to the board (or board committee(s)) which enables it to build up a cumulative assessment of the state of control in the company and the effectiveness with which risk is being managed;
- the incidence of significant control failings or weaknesses that have been identified at any time during the period and the extent to which they have resulted in unforeseen outcomes or contingencies that have had, could have had, or may in the future have, a material impact on the company's financial performance or condition; and
- the effectiveness of the company's public reporting processes.

- 32     Should the board become aware at any time of a significant failing or weakness in internal control, it should determine how the failing or weakness arose and reassess the effectiveness of management's ongoing processes for designing, operating and monitoring the system of internal control.

## THE BOARD'S STATEMENT ON INTERNAL CONTROL

- 33 The annual report and accounts should include such meaningful, high-level information as the board considers necessary to assist shareholders' understanding of the main features of the company's risk management processes and system of internal control, and should not give a misleading impression.
- 34 In its narrative statement of how the company has applied Code Principle C.2, the board should, as a minimum, disclose that there is an ongoing process for identifying, evaluating and managing the significant risks faced by the company, that it has been in place for the year under review and up to the date of approval of the annual report and accounts, that it is regularly reviewed by the board and accords with the guidance in this document.
- 35 The disclosures relating to the application of Principle C.2 should include an acknowledgement by the board that it is responsible for the company's system of internal control and for reviewing its effectiveness. It should also explain that such a system is designed to manage rather than eliminate the risk of failure to achieve business objectives, and can only provide reasonable and not absolute assurance against material misstatement or loss.
- 36 In relation to Code Provision C.2.1, the board should summarise the process it (where applicable, through its committees) has applied in reviewing the effectiveness of the system of internal control and confirm that necessary actions have been or are being taken to remedy any significant failings or weaknesses identified from that review. It should also disclose the process it has applied to deal with material internal control aspects of any significant problems disclosed in the annual report and accounts.
- 37 Where a board cannot make one or more of the disclosures in paragraphs 34 and 36, it should state this fact and provide an explanation. The Listing Rules require the board to disclose if it has failed to conduct a review of the effectiveness of the company's system of internal control.
- 38 Where material joint ventures and associates have not been dealt with as part of the group for the purposes of applying this guidance, this should be disclosed.

## APPENDIX

### Assessing the effectiveness of the company's risk and control processes

Some questions which the board may wish to consider and discuss with management when regularly reviewing reports on internal control and when carrying out its annual assessment are set out below. The questions are not intended to be exhaustive and will need to be tailored to the particular circumstances of the company.

This Appendix should be read in conjunction with the guidance set out in this document.

#### Risk assessment

- Does the company have clear objectives and have they been communicated so as to provide effective direction to employees on risk assessment and control issues? For example, do objectives and related plans include measurable performance targets and indicators?
- Are the significant internal and external operational, financial, compliance and other risks identified and assessed on an ongoing basis? These are likely to include the principal risks identified in the Operating and Financial Review.
- Is there a clear understanding by management and others within the company of what risks are acceptable to the board?

#### Control environment and control activities

- Does the board have clear strategies for dealing with the significant risks that have been identified? Is there a policy on how to manage these risks?
- Do the company's culture, code of conduct, human resource policies and performance reward systems support the business objectives and risk management and internal control system?
- Does senior management demonstrate, through its actions as well as its policies, the necessary commitment to competence, integrity and fostering a climate of trust within the company?
- Are authority, responsibility and accountability defined clearly such that decisions are made and actions taken by the appropriate people? Are the decisions and actions of different parts of the company appropriately co-ordinated?

- Does the company communicate to its employees what is expected of them and the scope of their freedom to act? This may apply to areas such as customer relations; service levels for both internal and outsourced activities; health, safety and environmental protection; security of tangible and intangible assets; business continuity issues; expenditure matters; accounting; and financial and other reporting.
- Do people in the company (and in its providers of outsourced services) have the knowledge, skills and tools to support the achievement of the company's objectives and to manage effectively risks to their achievement?
- How are processes/controls adjusted to reflect new or changing risks, or operational deficiencies?

### Information and communication

- Do management and the board receive timely, relevant and reliable reports on progress against business objectives and the related risks that provide them with the information, from inside and outside the company, needed for decision-making and management review purposes? This could include performance reports and indicators of change, together with qualitative information such as on customer satisfaction, employee attitudes etc.
- Are information needs and related information systems reassessed as objectives and related risks change or as reporting deficiencies are identified?
- Are periodic reporting procedures, including half-yearly and annual reporting, effective in communicating a balanced and understandable account of the company's position and prospects?
- Are there established channels of communication for individuals to report suspected breaches of law or regulations or other improprieties?

### Monitoring

- Are there ongoing processes embedded within the company's overall business operations, and addressed by senior management, which monitor the effective application of the policies, processes and activities related to internal control and risk management? (Such processes may include control self-assessment, confirmation by personnel of compliance with policies and codes of conduct, internal audit reviews or other management reviews).
- Do these processes monitor the company's ability to re-evaluate risks and adjust controls effectively in response to changes in its objectives, its business, and its external environment?

- Are there effective follow-up procedures to ensure that appropriate change or action occurs in response to changes in risk and control assessments?
- Is there appropriate communication to the board (or board committees) on the effectiveness of the ongoing monitoring processes on risk and control matters? This should include reporting any significant failings or weaknesses on a timely basis.
- Are there specific arrangements for management monitoring and reporting to the board on risk and control matters of particular importance? These could include, for example, actual or suspected fraud and other illegal or irregular acts, or matters that could adversely affect the company's reputation or financial position.

# GUIDANCE ON AUDIT COMMITTEES (The Smith Guidance)

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### Note

The following guidance is closely based on Sir Robert Smith's proposed guidance published in January 2003 (see footnote 2, page 1), modified for consistency with the final revised Code.



## AUDIT COMMITTEES - COMBINED CODE GUIDANCE

### 1. Introduction

- 1.1. This guidance is designed to assist company boards in making suitable arrangements for their audit committees, and to assist directors serving on audit committees in carrying out their role.
- 1.2. The paragraphs in bold are taken from the Combined Code (Section C3). Listed companies that do not comply with those provisions should include an explanation as to why they have not complied in the statement required by the Listing Rules.
- 1.3. Best practice requires that every board should consider in detail what arrangements for its audit committee are best suited for its particular circumstances. Audit committee arrangements need to be proportionate to the task, and will vary according to the size, complexity and risk profile of the company.
- 1.4. 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 that the interests of shareholders are properly protected in relation to financial reporting and internal control.
- 1.5. Nothing in the guidance should be interpreted as a departure from the principle of the unitary board. All directors remain equally responsible for the company's affairs as a matter of law. The audit committee, like other committees to which particular responsibilities are delegated (such as the remuneration committee), remains a committee of the board. Any disagreement within the board, including disagreement between the audit committee's members and the rest of the board, should be resolved at board level.
- 1.6. The Code provides that a separate section of the annual report should describe the work of the committee. This deliberately puts the spotlight on the audit committee and gives it an authority that it might otherwise lack. This is not incompatible with the principle of the unitary board.
- 1.7. The guidance contains recommendations about the conduct of the audit committee's relationship with the board, with the executive management and with internal and external auditors. However, the most important features of this relationship cannot be drafted as guidance or put into a code of practice: a frank, open working relationship and a high level of mutual respect are essential, particularly between the audit committee chairman and the board chairman, the chief executive and the finance director. 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.

- 1.8. In particular, the management is under an obligation to ensure the audit committee is kept properly informed, and should take the initiative in supplying information rather than waiting to be asked. The board should make it clear to all directors and staff that they must cooperate with the audit committee and provide it with any information it requires. In addition, executive board members will have regard to their common law duty to provide all directors, including those on the audit committee, with all the information they need to discharge their responsibilities as directors of the company.
- 1.9. Many of the core functions of audit committees set out in this guidance are expressed in terms of 'oversight', 'assessment' and 'review' of a particular function. It is not the duty of audit committees to carry out functions that properly belong to others, such as the company's management in the preparation of the financial statements or the auditors in the planning or conducting of audits. To do so could undermine the responsibility of management and auditors. Audit committees should, for example, satisfy themselves that there is a proper system and allocation of responsibilities for the day-to-day monitoring of financial controls but they should not seek to do the monitoring themselves.
- 1.10. However, the high-level oversight function may lead to detailed work. The audit committee must intervene if there are signs that something may be seriously amiss. For example, if the audit committee is uneasy about the explanations of management and auditors about a particular financial reporting policy decision, there may be no alternative but to grapple with the detail and perhaps to seek independent advice.
- 1.11. Under this guidance, audit committees have wide-ranging, time-consuming and sometimes intensive work to do. Companies need to make the necessary resources available. This includes suitable payment for the members of audit committees themselves. They – and particularly the audit committee chairman – bear a significant responsibility and they need to commit a significant extra amount of time to the job. Companies also need to make provision for induction and training for new audit committee members and continuing training as may be required.
- 1.12. This guidance applies to all companies to which the Code applies – i.e. UK listed companies. For groups, it will usually be necessary for the audit committee of the parent company to review issues that relate to particular subsidiaries or activities carried on by the group. Consequently, the board of a UK-listed parent company should ensure that there is adequate cooperation within the group (and with internal and external auditors of individual companies within the group) to enable the parent company audit committee to discharge its responsibilities effectively.

## **2 Establishment and role of the audit committee; membership, procedures and resources**

### **Establishment and role**

**2.1 The board should establish an audit committee of at least three, or in the case of smaller companies two, members.**

**2.2 The main role and responsibilities of the audit committee should be set out in written terms of reference and should include:**

- **to monitor the integrity of the financial statements of the company and any formal announcements relating to the company's financial performance, reviewing significant financial reporting judgements contained in them;**
- **to review the company's internal financial controls and, unless expressly addressed by a separate board risk committee composed of independent directors or by the board itself, the company's internal control and risk management systems;**
- **to monitor and review the effectiveness of the company's internal audit function;**
- **to make recommendations to the board, for it to put to the shareholders for their approval in general meeting, in relation to the appointment of the external auditor and to approve the remuneration and terms of engagement of the external auditor;**
- **to review and monitor the external auditor's independence and objectivity and the effectiveness of the audit process, taking into consideration relevant UK professional and regulatory requirements;**
- **to develop and implement policy on the engagement of the external auditor to supply non-audit services, taking into account relevant ethical guidance regarding the provision of non-audit services by the external audit firm;**

**and to report to the Board, identifying any matters in respect of which it considers that action or improvement is needed, and making recommendations as to the steps to be taken.**

## Membership and appointment

- 2.3 All members of the committee should 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.**
- 2.4 The chairman of the company should not be an audit committee member.
- 2.5 Appointments to the audit committee should be made by the board on the recommendation of the nomination committee (where there is one), in consultation with the audit committee chairman.
- 2.6 Appointments should be for a period of up to three years, extendable by no more than two additional three-year periods, so long as members continue to be independent.

## Meetings of the audit committee

- 2.7 It is for the audit committee chairman, in consultation with the company secretary, to decide the frequency and timing of its meetings. There should be as many meetings as the audit committee's role and responsibilities require. It is recommended there should be not fewer than three meetings during the year, held to coincide with key dates within the financial reporting and audit cycle<sup>1</sup>. However, most audit committee chairmen will wish to call more frequent meetings.
- 2.8 No one other than the audit committee's chairman and members is entitled to be present at a meeting of the audit committee. It is for the audit committee to decide if non-members should attend for a particular meeting or a particular agenda item. It is to be expected that the external audit lead partner will be invited regularly to attend meetings as well as the finance director. Others may be invited to attend.
- 2.9 Sufficient time should be allowed to enable the audit committee to undertake as full a discussion as may be required. A sufficient interval should be allowed between audit committee meetings and main board meetings to allow any work arising from the audit committee meeting to be carried out and reported to the board as appropriate.
- 2.10 The audit committee should, at least annually, meet the external and internal auditors, without management, to discuss matters relating to its remit and any issues arising from the audit.

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<sup>1</sup> For example, when the audit plans (internal and external) are available for review and when interim statements, preliminary announcements and the full annual report are near completion.

- 2.11 Formal meetings of the audit committee are the heart of its work. However, they will rarely be sufficient. It is expected that the audit committee chairman, and to a lesser extent the other members, will wish to keep in touch on a continuing basis with the key people involved in the company's governance, including the board chairman, the chief executive, the finance director, the external audit lead partner and the head of internal audit.

## **Resources**

- 2.12 The audit committee should be provided with sufficient resources to undertake its duties.
- 2.13 The audit committee should have access to the services of the company secretariat on all audit committee matters including: assisting the chairman in planning the audit committee's work, drawing up meeting agendas, maintenance of minutes, drafting of material about its activities for the annual report, collection and distribution of information and provision of any necessary practical support.
- 2.14 The company secretary should ensure that the audit committee receives information and papers in a timely manner to enable full and proper consideration to be given to the issues.
- 2.15 The board should make funds available to the audit committee to enable it to take independent legal, accounting or other advice when the audit committee reasonably believes it necessary to do so.

## **Remuneration**

- 2.16 In addition to the remuneration paid to all non-executive directors, each company should consider the further remuneration that should be paid to members of the audit committee to recompense them for the additional responsibilities of membership. 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. The level of remuneration paid to the members of the audit committee should take into account the level of fees paid to other members of the board. The chairman's responsibilities and time demands will generally be heavier than the other members of the audit committee and this should be reflected in his or her remuneration.

## **Skills, experience and training**

- 2.17 It is desirable that the committee member whom the board considers to have recent and relevant financial experience should have a professional qualification from one of the professional accountancy bodies. The need for a degree of financial literacy among the other members will vary according to the nature of the company, but experience of corporate financial matters will normally be required. The availability of appropriate financial expertise will be particularly important where the company's activities involve specialised financial activities.
- 2.18 The company should provide an induction programme for new audit committee members. This should cover the role of the audit committee, including its terms of reference and expected time commitment by members; and an overview of the company's business, identifying the main business and financial dynamics and risks. It could also include meeting some of the company staff.
- 2.19 Training should also be provided to members of the audit committee on an ongoing and timely basis and should include an understanding of the principles of and developments in financial reporting and related company law. In appropriate cases, it may also include, for example, understanding financial statements, applicable accounting standards and recommended practice; the regulatory framework for the company's business; the role of internal and external auditing and risk management.
- 2.20 The induction programme and ongoing training may take various forms, including attendance at formal courses and conferences, internal company talks and seminars, and briefings by external advisers.

## **3. Relationship with the board**

- 3.1 The role of the audit committee is for the board to decide and to the extent that the audit committee undertakes tasks on behalf of the board, the results should be reported to, and considered by, the board. In doing so it should identify any matters in respect of which it considers that action or improvement is needed, and make recommendations as to the steps to be taken.
- 3.2 The terms of reference should be tailored to the particular circumstances of the company.
- 3.3 The audit committee should review annually its terms of reference and its own effectiveness and recommend any necessary changes to the board.
- 3.4 The board should review the audit committee's effectiveness annually.

- 3.5 Where there is disagreement between the audit committee and the board, adequate time should be made available for discussion of the issue with a view to resolving the disagreement. Where any such disagreements cannot be resolved, the audit committee should have the right to report the issue to the shareholders as part of the report on its activities in the annual report.

## 4 Role and responsibilities

### Financial reporting

- 4.1 The audit committee should review the significant financial reporting issues and judgements made in connection with the preparation of the company's financial statements, interim reports, preliminary announcements and related formal statements.
- 4.2 It is management's, not the audit committee's, responsibility to prepare complete and accurate financial statements and disclosures in accordance with financial reporting standards and applicable rules and regulations. However the audit committee should consider significant accounting policies, any changes to them and any significant estimates and judgements. The 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. Taking into account the external auditor's view, the audit committee should consider whether the company has adopted appropriate accounting policies and, where necessary, made appropriate estimates and judgements. The audit committee should review the clarity and completeness of disclosures in the financial statements and consider whether the disclosures made are set properly in context.
- 4.3 Where, following its review, the audit committee is not satisfied with any aspect of the proposed financial reporting by the company, it shall report its views to the board.
- 4.4 The audit committee should review related information presented with the financial statements, including the operating and financial review, and corporate governance statements relating to the audit and to risk management. Similarly, where board approval is required for other statements containing financial information (for example, summary financial statements, significant financial returns to regulators and release of price sensitive information), whenever practicable (without being inconsistent with any requirement for prompt reporting under the Listing Rules) the audit committee should review such statements first.

**Internal controls and risk management systems**

- 4.5 The audit committee should review the company's internal financial controls (that is, the systems established to identify, assess, manage and monitor financial risks); and unless expressly addressed by a separate board risk committee comprised of independent directors or by the board itself, the company's internal control and risk management systems.
- 4.6 The company's management is responsible for the identification, assessment, management and monitoring of risk, for developing, operating and monitoring the system of internal control and for providing assurance to the board that it has done so. Except where the board or a risk committee is expressly responsible for reviewing the effectiveness of the internal control and risk management systems, the audit committee should receive reports from management on the effectiveness of the systems they have established and the conclusions of any testing carried out by internal and external auditors.
- 4.7 Except to the extent that this is expressly dealt with by the board or risk committee, the audit committee should review and approve the statements included in the annual report in relation to internal control and the management of risk.

**Whistleblowing**

- 4.8 **The audit committee should review arrangements by which staff of the company may, in confidence, raise concerns about possible improprieties in matters of financial reporting or other matters. The audit committee's objective should be to ensure that arrangements are in place for the proportionate and independent investigation of such matters and for appropriate follow-up action.**

**The internal audit process**

- 4.9 **The audit committee should monitor and review the effectiveness of the company's internal audit function. Where there is no internal audit function, the audit committee should consider annually whether there is a need for an internal audit function and make a recommendation to the board, and the reasons for the absence of such a function should be explained in the relevant section of the annual report.**
- 4.10 The need for an internal audit function will vary depending on company specific factors including the scale, diversity and complexity of the company's activities and the number of employees, as well as cost/benefit considerations. Senior management and the board may desire objective

assurance and advice on risk and control. An adequately resourced internal audit function (or its equivalent where, for example, a third party is contracted to perform some or all of the work concerned) may provide such assurance and advice. There may be other functions within the company that also provide assurance and advice covering specialist areas such as health and safety, regulatory and legal compliance and environmental issues.

- 4.11 When undertaking its assessment of the need for an internal audit function, the audit committee should also consider whether there are any trends or current factors relevant to the company's activities, markets or other aspects of its external environment, that have increased, or are expected to increase, the risks faced by the company. Such an increase in risk may also arise from internal factors such as organisational restructuring or from changes in reporting processes or underlying information systems. Other matters to be taken into account may include adverse trends evident from the monitoring of internal control systems or an increased incidence of unexpected occurrences.
- 4.12 In the absence of an internal audit function, management needs to apply other monitoring processes in order to assure itself, the audit committee and the board that the system of internal control is functioning as intended. In these circumstances, the audit committee will need to assess whether such processes provide sufficient and objective assurance.
- 4.13 The audit committee should review and approve the internal audit function's remit, having regard to the complementary roles of the internal and external audit functions. The audit committee should ensure that the function has the necessary resources and access to information to enable it to fulfil its mandate, and is equipped to perform in accordance with appropriate professional standards for internal auditors<sup>2</sup>.
- 4.14 The audit committee should approve the appointment or termination of appointment of the head of internal audit.
- 4.15 In its review of the work of the internal audit function, the audit committee should, inter alia:
- ensure that the internal auditor has direct access to the board chairman and to the audit committee and is accountable to the audit 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;

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<sup>2</sup> Further guidance can be found in the Institute of Internal Auditors' Code of Ethics and the International Standards for the Professional Practice of Internal Auditing Standards.

- 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 the presence of management; and
- monitor and assess the role and effectiveness of the internal audit function in the overall context of the company's risk management system.

### The external audit process

4.16 The audit committee is the body responsible for overseeing the company's relations with the external auditor.

#### *Appointment*

4.17 **The audit committee should have primary responsibility for making a recommendation on the appointment, reappointment and removal of the external auditors. If the board does not accept the audit committee's recommendation, it should include in the annual report, and in any papers recommending appointment or reappointment, a statement from the audit committee explaining its recommendation and should set out reasons why the board has taken a different position.**

4.18 The audit committee's recommendation to the board should be based on the assessments referred to below. If the audit committee recommends considering the selection of possible new appointees as external auditors, it should oversee the selection process.

4.19 The audit committee should assess annually the qualification, expertise and resources, and independence (see below) of the external auditors and the effectiveness of the audit process. The assessment should cover all aspects of the audit service provided by the audit firm, and include obtaining a report on the audit firm's own internal quality control procedures.

4.20 If the external auditor resigns, the audit committee should investigate the issues giving rise to such resignation and consider whether any action is required.

*Terms and Remuneration*

- 4.21 The audit committee should approve the terms of engagement and the remuneration to be paid to the external auditor in respect of audit services provided.
- 4.22 The audit committee should review and agree the engagement letter issued by the external auditor at the start of each audit, ensuring that it has been updated to reflect changes in circumstances arising since the previous year. The scope of the external audit should be reviewed by the audit committee with the auditor. If the audit committee is not satisfied as to its adequacy it should arrange for additional work to be undertaken.
- 4.23 The audit committee should satisfy itself that the level of fee payable in respect of the audit services provided is appropriate and that an effective audit can be conducted for such a fee.

*Independence, including the provision of non-audit services*

- 4.24 The audit committee should have procedures to ensure the independence and objectivity of the external auditor annually, taking into consideration relevant UK professional and regulatory requirements. This assessment should involve a consideration of all relationships between the company and the audit firm (including the provision of non-audit services). The audit committee should consider whether, taken as a whole and having regard to the views, as appropriate, of the external auditor, management and internal audit, those relationships appear to impair the auditor's judgement or independence.
- 4.25 The audit committee should seek reassurance that the auditors and their staff have no family, financial, employment, investment or business relationship with the company (other than in the normal course of business). The audit committee should seek from the audit firm, on an annual basis, information about policies and processes for maintaining independence and monitoring compliance with relevant requirements, including current requirements regarding the rotation of audit partners and staff.
- 4.26 The audit committee should agree with the board the company's policy for the employment of former employees of the external auditor, paying particular attention to the policy regarding former employees of the audit firm who were part of the audit team and moved directly to the company. This should be drafted taking into account the relevant ethical guidelines governing the accounting profession. The audit committee should monitor application of the policy, including the number of former employees of the external auditor currently employed in senior positions in the company, and consider whether in the light of this there has been any impairment,

or appearance of impairment, of the auditor's judgement or independence in respect of the audit.

4.27 The audit committee should monitor the external audit firm's compliance with applicable United Kingdom ethical guidance relating to the rotation of audit partners, the level of fees that the company pays in proportion to the overall fee income of the firm, office and partner, and other related regulatory requirements.

4.28 The audit committee should develop and recommend to the board the company's policy in relation to the provision of non-audit services by the auditor. The audit committee's objective should be to ensure that the provision of such services does not impair the external auditor's independence or objectivity. In this context, the audit committee should consider:

- whether the skills and experience of the audit firm make it a suitable supplier of the non audit service;
- whether there are safeguards in place to ensure that there is no threat to objectivity and independence in the conduct of the audit resulting from the provision of such services by the external auditor;
- the nature of the non-audit services, the related fee levels and the fee levels individually and in aggregate relative to the audit fee; and
- the criteria which govern the compensation of the individuals performing the audit.

4.29 The audit committee should set and apply a formal policy specifying the types of non-audit work:

- from which the external auditors are excluded;
- for which the external auditors can be engaged without referral to the audit committee; and
- for which a case-by-case decision is necessary.

In addition, the policy may set fee limits generally or for particular classes of work.

4.30 In the third category, if it is not practicable to give approval to individual items in advance, it may be appropriate to give a general pre-approval for certain classes for work, subject to a fee limit determined by the audit committee and ratified by the board. The subsequent provision of any service by the auditor should be ratified at the next meeting of the audit committee.

4.31 In determining the policy, the audit committee should take into account relevant ethical guidance regarding the provision of non-audit services by

the external audit firm, and in principle should not agree to the auditor providing a service if, having regard to the ethical guidance, the result is that:

- the external auditor audits its own firm's work;
- the external auditor makes management decisions for the company;
- a mutuality of interest is created; or
- the external auditor is put in the role of advocate for the company.

The audit committee should satisfy itself that any safeguards required by ethical guidance are implemented.

**4.32 The annual report should explain to shareholders how, if the auditor provides non-audit services, auditor objectivity and independence is safeguarded.**

*Annual audit cycle*

4.33 At the start of each annual audit cycle, the audit committee should ensure that appropriate plans are in place for the audit.

4.34 The audit committee should consider whether the auditor's overall work plan, including planned levels of materiality, and proposed resources to execute the audit plan appears consistent with the scope of the audit engagement, having regard also to the seniority, expertise and experience of the audit team.

4.35 The audit committee should review, with the external auditors, the findings of their work. In the course of its review, the audit committee should:

- discuss with the external auditor major issues that arose during the course of the audit and have subsequently been resolved and those issues that have been left unresolved;
- review key accounting and audit judgements; and
- 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.

4.36 The audit committee should also review the audit representation letters before signature by management and give particular consideration to matters where representation has been requested that relate to non-standard issues<sup>3</sup>. The audit committee should consider whether the

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<sup>3</sup> Further guidance can be found in the Auditing Practices Board's Statement of Auditing Standard 440 "Management Representations".

information provided is complete and appropriate based on its own knowledge.

- 4.37 As part of the ongoing monitoring process, the audit committee should review the management letter (or equivalent). The audit committee should review and monitor management's responsiveness to the external auditor's findings and recommendations.
- 4.38 At the end of the annual audit cycle, the audit committee should assess the effectiveness of the audit process. In the course of doing so, the audit committee should:
- review whether the auditor has met the agreed audit plan and understand the reasons for any changes, including changes in perceived audit risks and the work undertaken by the external auditors to address those risks;
  - consider the robustness and perceptiveness of the auditors in their handling of the key accounting and audit judgements identified and in responding to questions from the audit committees, and in their commentary where appropriate on the systems of internal control;
  - obtain feedback about the conduct of the audit from key people involved, e.g. the finance director and the head of internal audit; and
  - review and monitor the content of the external auditor's management letter, in order to assess whether it is based on a good understanding of the company's business and establish whether recommendations have been acted upon and, if not, the reasons why they have not been acted upon.

## 5 Communication with shareholders

- 5.1 The terms of reference of the audit committee, including its role and the authority delegated to it by the board, should be made available. A separate section in the annual report should describe the work of the committee in discharging those responsibilities.
- 5.2 The audit committee section should include, inter alia:
- a summary of the role of the audit committee;
  - the names and qualifications of all members of the audit committee during the period;
  - the number of audit committee meetings;
  - a report on the way the audit committee has discharged its responsibilities; and
  - the explanation provided for in paragraph 4.29 above.

- 5.3 The chairman of the audit committee should be present at the AGM to answer questions, through the chairman of the board, on the report on the audit committee's activities and matters within the scope of audit committee's responsibilities.



# SUGGESTIONS FOR GOOD PRACTICE FROM THE HIGGS REPORT

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## GUIDANCE ON THE ROLE OF THE CHAIRMAN

The chairman is pivotal in creating the conditions for overall board and individual director effectiveness, both inside and outside the boardroom. Specifically, it is the responsibility of the chairman to:

- run the board and set its agenda. The agenda should take full account of the issues and the concerns of all board members. Agendas should be forward looking and concentrate on strategic matters rather than formulaic approvals of proposals which can be the subject of appropriate delegated powers to management;
- ensure that the members of the board receive accurate, timely and clear information, in particular about the company's performance, to enable the board to take sound decisions, monitor effectively and provide advice to promote the success of the company;
- ensure effective communication with shareholders and ensure that the members of the board develop an understanding of the views of the major investors;
- manage the board to ensure that sufficient time is allowed for discussion of complex or contentious issues, where appropriate arranging for informal meetings beforehand to enable thorough preparation for the board discussion. It is particularly important that non-executive directors have sufficient time to consider critical issues and are not faced with unrealistic deadlines for decision-making;
- take the lead in providing a properly constructed induction programme for new directors that is comprehensive, formal and tailored, facilitated by the company secretary;
- take the lead in identifying and meeting the development needs of individual directors, with the company secretary having a key role in facilitating provision. It is the responsibility of the chairman to address the development needs of the board as a whole with a view to enhancing its overall effectiveness as a team;
- ensure that the performance of individuals and of the board as a whole and its committees is evaluated at least once a year; and
- encourage active engagement by all the members of the board.

### The effective chairman:

- upholds the highest standards of integrity and probity;
- sets the agenda, style and tone of board discussions to promote

- effective decision-making and constructive debate;
- promotes effective relationships and open communication, both inside and outside the boardroom, between non-executive directors and executive team;
- builds an effective and complementary board, initiating change and planning succession in board appointments, subject to board and shareholders' approval;
- promotes the highest standards of corporate governance and seeks compliance with the provisions of the Code wherever possible;
- ensures clear structure for and the effective running of board committees;
- ensures effective implementation of board decisions;
- establishes a close relationship of trust with the chief executive, providing support and advice while respecting executive responsibility; and
- provides coherent leadership of the company, including representing the company and understanding the views of shareholders.

## GUIDANCE ON THE ROLE OF THE NON-EXECUTIVE DIRECTOR

As members of the unitary board, all directors are required to:

- Provide entrepreneurial leadership of the company within a framework of prudent and effective controls which enable risk to be assessed and managed;
- 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; and
- Set the company's values and standards and ensure that its obligations to its shareholders and others are understood and met.

In addition to these requirements for all directors, the role of the non-executive director has the following key elements:

- **Strategy.** Non-executive directors should constructively challenge and help develop proposals on strategy.
- **Performance.** Non-executive directors should scrutinise the performance of management in meeting agreed goals and objectives and monitor the reporting of performance.
- **Risk.** Non-executive directors should satisfy themselves on the integrity of financial information and that financial controls and systems of risk management are robust and defensible.
- **People.** Non-executive directors are responsible for determining appropriate levels of remuneration of executive directors, and have a prime role in appointing, and where necessary removing, executive directors and in succession planning.

Non-executive directors should constantly seek to establish and maintain confidence in the conduct of the company. They should be independent in judgement and have an enquiring mind. To be effective, non-executive directors need to build a recognition by executives of their contribution in order to promote openness and trust.

To be effective, non-executive directors need to be well-informed about the company and the external environment in which it operates, with a strong

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<sup>1</sup> A smaller company is one that is below the FTSE 350 throughout the year immediately prior to the reporting year.

<sup>2</sup> Some companies require the remuneration committee to consider the packages of all executives at or above a specified level such as those reporting to a main board director whilst others require the committee to deal with all packages above a certain figure.

<sup>3</sup> Remuneration committees should consider reviewing and agreeing a standard form of contract for their executive directors, and ensuring that new appointees are offered and accept terms within the previously agreed level.

command of issues relevant to the business. A non-executive director should insist on a comprehensive, formal and tailored induction. An effective induction need not be restricted to the boardroom, so consideration should be given to visiting sites and meeting senior and middle management. Once in post, an effective non-executive director should seek continually to develop and refresh their knowledge and skills to ensure that their contribution to the board remains informed and relevant.

Best practice dictates that an effective non-executive director will ensure that information is provided sufficiently in advance of meetings to enable thorough consideration of the issues facing the board. The non-executive should insist that information is sufficient, accurate, clear and timely.

An element of the role of the non-executive director is to understand the views of major investors both directly and through the chairman and the senior independent director.

#### **The effective non-executive director:**

- upholds the highest ethical standards of integrity and probity;
- supports executives in their leadership of the business while monitoring their conduct;
- questions intelligently, debates constructively, challenges rigorously and decides dispassionately;
- listens sensitively to the views of others, inside and outside the board;
- gains the trust and respect of other board members; and
- promotes the highest standards of corporate governance and seeks compliance with the provisions of the Code wherever possible.

## SUMMARY OF THE PRINCIPAL DUTIES OF THE REMUNERATION COMMITTEE

The Code provides that the remuneration committee should consist exclusively of independent non-executive directors and should comprise at least three or, in the case of smaller companies<sup>1</sup>, two such directors.

### Duties

The committee should:

- determine and agree with the board the framework or broad policy for the remuneration of the chief executive, the chairman of the company and such other members of the executive management as it is designated to consider<sup>2</sup>. At a minimum, the committee should have delegated responsibility for setting remuneration for all executive directors, the chairman and, to maintain and assure their independence, the company secretary. The remuneration of non-executive directors shall be a matter for the chairman and executive members of the board. No director or manager should be involved in any decisions as to their own remuneration;
- determine targets for any performance-related pay schemes operated by the company;
- determine the policy for and scope of pension arrangements for each executive director;
- ensure that contractual terms on termination, and any payments made, are fair to the individual and the company, that failure is not rewarded and that the duty to mitigate loss is fully recognised<sup>3</sup>;
- within the terms of the agreed policy, determine the total individual remuneration package of each executive director including, where appropriate, bonuses, incentive payments and share options;
- in determining such packages and arrangements, give due regard to the contents of the Code as well as the UK Listing Authority's Listing Rules and associated guidance;
- be aware of and advise on any major changes in employee benefit structures throughout the company or group;

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<sup>1</sup> A smaller company is one that is below the FTSE 350 throughout the year immediately prior to the reporting year.

<sup>2</sup> Some companies require the remuneration committee to consider the packages of all executives at or above a specified level such as those reporting to a main board director whilst others require the committee to deal with all packages above a certain figure.

<sup>3</sup> Remuneration committees should consider reviewing and agreeing a standard form of contract for their executive directors, and ensuring that new appointees are offered and accept terms within the previously agreed level.

- agree the policy for authorising claims for expenses from the chief executive and chairman;
- ensure that provisions regarding disclosure of remuneration, including pensions, as set out in the Directors' Remuneration Report Regulations 2002 and the Code, are fulfilled;
- be exclusively responsible for establishing the selection criteria, selecting, appointing and setting the terms of reference for any remuneration consultants who advise the committee;
- report the frequency of, and attendance by members at, remuneration committee meetings in the annual reports; and
- make available the committee's terms of reference. These should set out the committee's delegated responsibilities and be reviewed and, where necessary, updated annually.

This guidance has been compiled with the assistance of ICSA who have kindly agreed to produce updated guidance on their website [www.icsa.org.uk](http://www.icsa.org.uk) in the future.

## SUMMARY OF THE PRINCIPAL DUTIES OF THE NOMINATION COMMITTEE

There should be a nomination committee which should lead the process for board appointments and make recommendations to the board.

A majority of members of the committee should be independent non-executive directors. The chairman or an independent non-executive director should chair the committee, but the chairman should not chair the nomination committee when it is dealing with the appointment of a successor to the chairmanship.

### Duties

The committee should:

- be responsible for identifying and nominating for the approval of the board, candidates to fill board vacancies as and when they arise;
- before making an appointment, evaluate the balance of skills, knowledge and experience on the board and, in the light of this evaluation, prepare a description of the role and capabilities required for a particular appointment;
- review annually the time required from a non-executive director. Performance evaluation should be used to assess whether the non-executive director is spending enough time to fulfil their duties;
- consider candidates from a wide range of backgrounds and look beyond the “usual suspects”;
- give full consideration to succession planning in the course of its work, taking into account the challenges and opportunities facing the company and what skills and expertise are therefore needed on the board in the future;
- regularly review the structure, size and composition (including the skills, knowledge and experience) of the board and make recommendations to the board with regard to any changes;
- keep under review the leadership needs of the organisation, both executive and non-executive, with a view to ensuring the continued ability of the organisation to compete effectively in the marketplace;
- make a statement in the annual report about its activities; the process used for appointments and explain if external advice or open advertising has not been used; the membership of the committee, number of committee meetings and attendance over the course of the year;

- make available its terms of reference explaining clearly its role and the authority delegated to it by the board; and
- ensure that on appointment to the board, non-executive directors receive a formal letter of appointment setting out clearly what is expected of them in terms of time commitment, committee service and involvement outside board meetings.

The committee should make recommendations to the board:

- as regards plans for succession for both executive and non-executive directors;
- as regards the re-appointment of any non-executive director at the conclusion of their specified term of office;
- concerning the re-election by shareholders of any director under the retirement by rotation provisions in the company's articles of association;
- concerning any matters relating to the continuation in office of any director at any time; and
- concerning the appointment of any director to executive or other office other than to the positions of chairman and chief executive, the recommendation for which would be considered at a meeting of the board.

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## **PRE-APPOINTMENT DUE DILIGENCE CHECKLIST FOR NEW BOARD MEMBERS**

### **Why?**

Before accepting an appointment a prospective non-executive director should undertake their own thorough examination of the company to satisfy themselves that it is an organisation in which they can have faith and in which they will be well suited to working.

The following questions are not intended to be exhaustive, but are intended to be a helpful basis of the pre-appointment due diligence process that all non-executive directors should undertake.

### **Questions to ask**

What is the company's current financial position and what has its financial track record been over the last three years?

What are the key dependencies (e.g. regulatory approvals, key licences, etc)?

What record does the company have on corporate governance issues?

If the company is not performing particularly well is there potential to turn it round and do I have the time, desire and capability to make a positive impact?

What are the exact nature and extent of the company's business activities?

Who are the current executive and non-executive directors, what is their background and their record and how long have they served on the board?

What is the size and structure of the board and board committees and what are the relationships between the chairman and the board, the chief executive and the management team?

Who owns the company i.e. who are the company's main shareholders and how has the profile changed over recent years? What is the company's attitude towards, and relationship with, its shareholders?

Is any material litigation presently being undertaken or threatened, either by the company or against it?

Is the company clear and specific about the qualities, knowledge, skills and experience that it needs to complement the existing board?

What insurance cover is available to directors and what is the company's policy on indemnifying directors?

Do I have the necessary knowledge, skills, experience and time to make a positive contribution to the board of this company?

How closely do I match the job specification and how well will I fulfil the board's expectations?

Is there anything about the nature and extent of the company's business activities that would cause me concern both in terms of risk and any personal ethical considerations?

Am I satisfied that the internal regulation of the company is sound and that I can operate effectively within its stated corporate governance framework?

Am I satisfied that the size, structure and make-up of the board will enable me to make an effective contribution?

Would accepting the non-executive directorship put me in a position of having a conflict of interest?

### Sources of information

- Company report and accounts, and/or any listing prospectus, for the recent years.
- Analyst reports.
- Press reports
- Company web site
- Any Corporate Social Responsibility or Environmental Report issued by the company.
- Rating agency reports
- Voting services reports

Published material is unlikely to reveal wrong-doing, however a lack of transparency may be a reason to proceed with caution.

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## **SAMPLE LETTER OF NON-EXECUTIVE DIRECTOR APPOINTMENT**

On [date], upon the recommendation of the nomination committee, the board of [company] ('the Company') has appointed you as non-executive director. I am writing to set out the terms of your appointment. It is agreed that this is a contract for services and is not a contract of employment.

### **Appointment**

Your appointment will be for an initial term of three years commencing on [date], unless otherwise terminated earlier by and at the discretion of either party upon [one month's] written notice. Continuation of your contract of appointment is contingent on satisfactory performance and re-election at forthcoming AGM's. Non-executive directors are typically expected to serve two three-year terms, although the board may invite you to serve an additional period.

### **Time commitment**

Overall we anticipate a time commitment of [number] days per month after the induction phase. This will include attendance at [monthly] board meetings, the AGM, [one] annual board away day, and [at least one] site visit per year. In addition, you will be expected to devote appropriate preparation time ahead of each meeting.

By accepting this appointment, you have confirmed that you are able to allocate sufficient time to meet the expectations of your role. The agreement of the chairman should be sought before accepting additional commitments that might impact on the time you are able to devote to your role as a non-executive director of the company.

### **Role**

Non-executive directors have the same general legal responsibilities to the company as any other director. The board as a whole is collectively responsible for the success of the company. The board:

- Provides entrepreneurial leadership of the company within a framework of prudent and effective controls which enable risk to be assessed and managed;
- Sets the company's strategic aims, ensures that the necessary financial and human resources are in place for the company to meet its objectives, and reviews management performance; and

- Sets the company's values and standards and ensure that its obligations to its shareholders and others are understood and met.

All directors must take decisions objectively in the interests of the company.

In addition to these requirements of all directors, the role of the non-executive director has the following key elements:

- **Strategy.** Non-executive directors should constructively challenge and help develop proposals on strategy;
- **Performance.** Non-executive directors should scrutinise the performance of management in meeting agreed goals and objectives and monitor the reporting of performance;
- **Risk.** Non-executive directors should satisfy themselves on the integrity of financial information and that financial controls and systems of risk management are robust and defensible; and
- **People.** Non-executive directors are responsible for determining appropriate levels of remuneration of executive directors and have a prime role in appointing, and where necessary removing, executive directors and in succession planning.

## Fees

You will be paid a fee of £[amount] gross per annum which will be paid monthly in arrears, [plus [number] ordinary shares of the company per annum, both of] which will be subject to an annual review by the board. The company will reimburse you for all reasonable and properly documented expenses you incur in performing the duties of your office.

## Outside interests

It is accepted and acknowledged that you have business interests other than those of the company and have declared any conflicts that are apparent at present. In the event that you become aware of any potential conflicts of interest, these should be disclosed to the chairman and company secretary as soon as apparent.

[The board of the Company have determined you to be independent according to provision A.3.1 of the Code.]

## Confidentiality

All information acquired during your appointment is confidential to the Company and should not be released, either during your appointment or following termination (by whatever means), to third parties without prior clearance from the chairman.

Your attention is also drawn to the requirements under both legislation and regulation as to the disclosure of price sensitive information. Consequently you should avoid making any statements that might risk a breach of these requirements without prior clearance from the chairman or company secretary.

## Induction

Immediately after appointment, the Company will provide a comprehensive, formal and tailored induction. This will include the information pack recommended by the Institute of Chartered Secretaries and Administrators (ICSA), available at [www.icsa.org.uk](http://www.icsa.org.uk). We will also arrange for site visits and meetings with senior and middle management and the Company's auditors. We will also offer to major shareholders the opportunity to meet you.

## Review process

The performance of individual directors and the whole board and its committees is evaluated annually. If, in the interim, there are any matters which cause you concern about your role you should discuss them with the chairman as soon as is appropriate.

## Insurance

The Company has directors' and officers' liability insurance and it is intended to maintain such cover for the full term of your appointment. The current indemnity limit is £ [amount]; a copy of the policy document is attached.

## Independent professional advice

Occasions may arise when you consider that you need professional advice in the furtherance of your duties as a director. Circumstances may occur when it will be appropriate for you to seek advice from independent advisors at the company's expense. A copy of the board's agreed procedure under which directors may obtain such independent advice is attached. The Company will reimburse the full cost of expenditure incurred in accordance with the attached policy.

## Committees

This letter refers to your appointment as a non-executive director of the Company. In the event that you are also asked to serve on one or more of the board committees this will be covered in a separate communication setting out the committee(s)'s terms of reference, any specific responsibilities and any additional fees that may be involved.

This sample appointment letter has been compiled with the assistance of ICSA who have kindly agreed to produce updated guidance on their website [www.icsa.org.uk](http://www.icsa.org.uk) in the future.

## INDUCTION CHECKLIST

### Guidance on Induction

Every company should develop its own comprehensive, formal induction programme that is tailored to the needs of the company and individual non-executive directors. The following guidelines might form the core of an induction programme.

As a general rule, a combination of selected written information together with presentations and activities such as meetings and site visits will help to give a new appointee a balanced and real-life overview of the company. Care should be taken not to overload the new director with too much information. The new non-executive director should be provided with a list of all the induction information that is being made available to them so that they may call up items if required before otherwise provided.

The induction process should:

1. Build an understanding of the **nature of the company, its business and the markets in which it operates**. For example, induction should cover:
  - the company's products or services;
  - group structure / subsidiaries / joint ventures;
  - the company's constitution, board procedures and matters reserved for the board;
  - summary details of the company's principal assets, liabilities, significant contracts and major competitors;
  - the company's major risks and risk management strategy;
  - key performance indicators; and
  - regulatory constraints.
2. Build a link with the **company's people** including:
  - meetings with senior management;
  - visits to company sites other than the headquarters, to learn about production or services and meet employees in an informal setting. It is important, not only for the board to get to know the new non-executive director, but also for the non-executive director to build a profile with employees below board level; and
  - participating in board strategy development. 'Awaydays' enable a new non-executive director to begin to build working relationships away from the formal setting of the boardroom.

3. Build an understanding of the **company's main relationships** including meeting with the auditors and developing a knowledge of in particular:
- who are the major customers;
  - who are the major suppliers; and
  - who are the major shareholders and what is the shareholder relations policy – participation in meetings with shareholders can help give a first hand feel as well as letting shareholders know who the non-executive directors are.

### The induction pack

On appointment, or during the weeks immediately following, a new non-executive director should be provided with certain basic information to help ensure their early effective contribution to the company. ICSA has produced, and undertaken to maintain, on their website [www.icsa.org.uk](http://www.icsa.org.uk) a guidance note detailing a full list of such material.

## PERFORMANCE EVALUATION GUIDANCE

### Guidance on performance evaluation

The Code provides that the board should undertake a formal and rigorous annual evaluation of its own performance and that of its committees and individual directors. Individual evaluation should aim to show whether each director continues to contribute effectively and to demonstrate commitment to the role (including commitment of time for board and committee meetings and any other duties). The chairman should act on the results of the performance evaluation by recognising the strengths and addressing the weaknesses of the board and, where appropriate, proposing new members be appointed to the board or seeking the resignation of directors. The board should state in the annual report how such performance evaluation has been conducted.

It is the responsibility of the chairman to select an effective process and to act on its outcome. The use of an external third party to conduct the evaluation will bring objectivity to the process.

The non-executive directors, led by the senior independent director, should be responsible for performance evaluation of the chairman, taking into account the views of executive directors.

The evaluation process will be used constructively as a mechanism to improve board effectiveness, maximise strengths and tackle weaknesses. The results of board evaluation should be shared with the board as a whole while the results of individual assessments should remain confidential between the chairman and the non-executive director concerned.

The following are some of the questions that should be considered in a performance evaluation. They are, however, by no means definitive or exhaustive and companies will wish to tailor the questions to suit their own needs and circumstances.

The responses to these questions and others should enable boards to assess how they are performing and to identify how certain elements of their performance areas might be improved.

### Performance evaluation of the board

- How well has the board performed against any performance objectives that have been set?
- What has been the board's contribution to the testing and development of strategy?

- What has been the board's contribution to ensuring robust and effective risk management?
- Is the composition of the board and its committees appropriate, with the right mix of knowledge and skills to maximise performance in the light of future strategy? Are inside and outside the board relationships working effectively?
- How has the board responded to any problems or crises that have emerged and could or should these have been foreseen?
- Are the matters specifically reserved for the board the right ones?
- How well does the board communicate with the management team, company employees and others? How effectively does it use mechanisms such as the AGM and the annual report?
- Is the board as a whole up to date with latest developments in the regulatory environment and the market?
- How effective are the board's committees? [Specific questions on the performance of each committee should be included such as, for example, their role, their composition and their interaction with the board.]

The processes that help underpin the board's effectiveness should also be evaluated e.g.:

- Is appropriate, timely information of the right length and quality provided to the board and is management responsive to requests for clarification or amplification? Does the board provide helpful feedback to management on its requirements?
- Are sufficient board and committee meetings of appropriate length held to enable proper consideration of issues? Is time used effectively?
- Are board procedures conducive to effective performance and flexible enough to deal with all eventualities?

In addition, there are some specific issues relating to the chairman which should be included as part of an evaluation of the board's performance e.g.:

- Is the chairman demonstrating effective leadership of the board?
- Are relationships and communications with shareholders well managed?
- Are relationships and communications within the board constructive?
- Are the processes for setting the agenda working? Do they enable board members to raise issues and concerns?

- Is the company secretary being used appropriately and to maximum value?

### Performance evaluation of the non-executive director

The chairman and other board members should consider the following issues and the individual concerned should also be asked to assess themselves. For each non-executive director:

- How well prepared and informed are they for board meetings and is their meeting attendance satisfactory?
- Do they demonstrate a willingness to devote time and effort to understand the company and its business and a readiness to participate in events outside the boardroom such as site visits?
- What has been the quality and value of their contributions at board meetings?
- What has been their contribution to development of strategy and to risk management?
- How successfully have they brought their knowledge and experience to bear in the consideration of strategy?
- How effectively have they probed to test information and assumptions? Where necessary, how resolute are they in maintaining their own views and resisting pressure from others?
- How effectively and proactively have they followed up their areas of concern?
- How effective and successful are their relationships with fellow board members, the company secretary and senior management? Does their performance and behaviour engender mutual trust and respect within the board?
- How actively and successfully do they refresh their knowledge and skills and are they up to date with:
  - the latest developments in areas such as corporate governance framework and financial reporting ?
  - the industry and market conditions?
- How well do they communicate with fellow board members, senior management and others, for example shareholders? Are they able to present their views convincingly yet diplomatically and do they listen and take on board the views of others?



## USEFUL WEB LINKS

The Financial Services Authority's Listing Rules (2005) (see in particular paragraph 9.8.6):

<http://www.fsahandbook.info/FSA/handbook.jsp?doc=/handbook/LR>

The Higgs Review (2003), together with full details of the research conducted for the Review and related information:

[http://www.dti.gov.uk/cld/non\\_exec\\_review](http://www.dti.gov.uk/cld/non_exec_review)

The Smith Report (2003):

<http://www.frc.org.uk/images/uploaded/documents/ACReport.pdf>

The Directors' Remuneration Report Regulations 2002:

<http://www.hmso.gov.uk/si/si2002/20021986.htm>

The Tyson report on the Recruitment and Development of Non-Executive Directors (2003):

[http://www.womenandequalityunit.gov.uk/publications/Tyson\\_report.doc](http://www.womenandequalityunit.gov.uk/publications/Tyson_report.doc)

The Cadbury Report (1992), Greenbury Report (1995) and Hampel Report (1998):

[http://www.ecgi.org/codes/all\\_codes.php](http://www.ecgi.org/codes/all_codes.php)

Copies of guidance produced by the Institute of Chartered Secretaries and Administrators:

<http://www.icsa.org.uk>

The Institutional Shareholders' Committee's document 'The Responsibilities of Institutional Shareholders and Agents – Statement of Principles' (2005):

<http://www.aitc.co.uk/files/technical/StatementofPrinciplesRevisedFinalSeptember200511.pdf>

The Myners Report on Institutional Investment in the UK (2001) and follow-up report (2004):

[http://www.hm-treasury.gov.uk/Documents/Financial\\_Services/Securities\\_and\\_Investments/fin\\_sec\\_Mynfinal.cfm](http://www.hm-treasury.gov.uk/Documents/Financial_Services/Securities_and_Investments/fin_sec_Mynfinal.cfm)

The report of the EU High Level Group of Company Law Experts (the “Winter group”) (2002);

The European Commission’s Action Plan for Company Law and Corporate Governance (2003):

[http://europa.eu.int/comm/internal\\_market/en/company/company/modern/index.htm](http://europa.eu.int/comm/internal_market/en/company/company/modern/index.htm)

Corporate governance codes in other countries:

[http://www.ecgi.org/codes/all\\_codes.php](http://www.ecgi.org/codes/all_codes.php)





FINANCIAL REPORTING COUNCIL  
HOLBORN HALL  
100 GRAY'S INN ROAD  
LONDON WC1X 8AL  
TELEPHONE 020 7611 9700  
WEBSITES  
<http://www.frc.org.uk>  
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<http://www.frrp.org.uk>