Consultation

Financial Reporting Council

December 2017

Proposed Revisions to the UK Corporate Governance Code

Appendix B – Revised Guidance on Board Effectiveness

The FRC's mission is to promote transparency and integrity in business. The FRC sets the UK Corporate Governance and Stewardship Codes and UK standards for accounting and actuarial work; monitors and takes action to promote the quality of corporate reporting; and operates independent enforcement arrangements for accountants and actuaries. As the Competent Authority for audit in the UK the FRC sets auditing and ethical standards and monitors and enforces audit quality.

CONTENTS

INTRODUCTION

1. The *Guidance on Board Effectiveness* (the Guidance) is intended to assist companies in applying the principles of the UK Corporate Governance Code (the Code). The Guidance is not mandatory. It sets out good practice suggestions for meeting the Principles and Provisions of the Code and is not intended to be prescriptive.

2. It is intended to stimulate boards' thinking on how they can carry out their role and encourage them to focus on continually improving their effectiveness. Ultimately it is for individual boards to decide on the governance arrangements most appropriate to their company's circumstances using the best practice set out in the Code and guidance.

3. The Code has evolved since it was first introduced in 1992. It has always placed great importance on clarity of roles and responsibilities, and on accountability and transparency. While these are necessary for good governance, they are not sufficient on their own. The structures and processes that boards put in place are essential for them to function effectively and efficiently, but on their own they will not deliver an effective board.

4. Boards need to think deeply about the way in which they carry out their role, the behaviours that they display, the way the company conducts business and engages with and reports to shareholders and wider stakeholders.

5. An approach to governance that places greater emphasis on decision-making and outcomes is reflected in the most recent edition of the Code, published in 2018, and also in the Guidance. For example, by promoting a more inclusive approach to stakeholder engagement and by encouraging boards to consider how the way in which decisions are taken might affect the quality of those decisions. By broadening boards' focus beyond the confines of the boardroom itself, opening boards up to different voices and influences, the Guidance supports openness and accountability in delivering the long-term success of the company.

6. The structure of the Guidance follows the structure of the Code and elaborates primarily on the matters related to board effectiveness dealt with in Sections 1-3 of the Code. The FRC has issued separate guidance on the audit, risk and internal control section. There is also guidance provided here on the role of the remuneration committee and the board's role in overseeing remuneration and other policies pertaining to the wider workforce.

7. The Guidance includes some of the procedural aspects of governance, which, historically, were covered by the Code. Such former features of the Code are now well-established as good practice and compliance levels are extremely high. The Guidance is intended to act as a reminder to boards and their support teams that good practice and procedure should continue to be followed.

8. The tools and techniques for board effectiveness suggested in the Guidance should assist companies in applying the Principles in the Code and could be drawn upon to illustrate in the annual report how the Principles have been applied.

1. LEADERSHIP AND PURPOSE

AN EFFECTIVE BOARD

9. An effective board develops and promotes its collective vision of the company's purpose, along with the values and the behaviours it wishes to promote in conducting its business and sets a strategy consistent with these. It will be able to explain how events or developments affecting the long-term success of the company have been addressed.

10. At the heart of a director's duties (see Figure One) lies a focus on generating and preserving value for shareholders for the long-term, taking account of the interests of the company's workforce and the impact on other stakeholders such as customers, suppliers, the community and the environment.

Figure One – UK Companies Act 2006, Section 172

(1) A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to –

a. the likely consequences of any decision in the long term,

b. the interests of the company's employees,

c. the need to foster the company's business relationships with suppliers, customers and others,

d. the impact of the company's operations on the community and the environment,

e. the desirability of the company maintaining a reputation for high standards of business conduct, and

f. the need to act fairly as between members of the company.

11. An effective board will have a clear understanding of how that value is dependent on relationships with its stakeholders, and will be able to explain how these relationships help deliver the company's purpose. It understands the importance of dialogue with shareholders, workforce and wider stakeholders and is pro-active in ensuring that such dialogue takes place.

12. Meeting sufficiently regularly is essential for the board to discharge its duties effectively and to allow adequate time for consideration of all the issues falling within its remit. Ensuring there is a formal schedule of matters specifically reserved for its decision will assist the board's planning and provide clarity to all over where responsibility for decision-making lies. The terms of reference and formal schedule of matters should be made available on the company website.

13. The boardroom should not necessarily be a comfortable place. Challenge, as well as teamwork, is an essential feature. Diversity in board composition is an important driver of a board's effectiveness, creating a breadth of perspective among directors, and breaking down a tendency towards 'group think'.

Questions for boards

- Have we clearly set the company's purpose, strategy and values, identified the significant risks and provided enough direction for management?
- How do we obtain assurance that management is identifying and addressing future challenges and opportunities, for example as a result of technological change or changing stakeholder expectations?
- How do we ensure that the board makes well-informed and high-quality decisions based on a clear line of sight into the business?
- Have we considered its implementation, feasibility and impact on stakeholders as well as its impact on financial performance?
- What percentage of board time is spent on financial and behavioural performance management and is the balance right?
- How do we make sure the voice of the workforce, customers and wider stakeholders is heard at board-level and what impact has this had on our decisions?
- How do we obtain assurance that the culture we are leading is open, accountable and aligned to purpose, strategy and values?

DECISION MAKING

14. Well-informed and high-quality decision making is a critical requirement for a board to be effective and does not happen by accident. Many of the factors which lead to poor decision making are predictable and preventable. Boards can minimise the risk of poor decisions by investing time in the design of their decision-making policies and processes, including the contribution of committees and obtaining input from stakeholders and expert opinions when necessary.

15. Boards should be aware of factors which can limit effective decision making, such as:

    - a dominant personality or group of directors on the board, which can inhibit contribution from other directors;
    - insufficient diversity and breadth of perspective on the board, which can contribute to 'group think';
    - inappropriate approach to risk, either excess focus on risk mitigation or insufficient attention to risk, and treating risk as a compliance issue rather than as part of the decision-making process – especially cases where the level of risk involved in a project could endanger the stability and sustainability of the business itself;
    - failure to listen and to act upon concerns that are raised;
    - failure to recognise the consequences of running the business on the basis of self-interest and other poor ethical standards;
    - a lack of openness by management, a reluctance to involve non-executive directors, or a tendency to bring matters to the board for sign-off rather than debate;
    - complacent or intransigent attitudes;
    - a weak organisational culture; or
    - inadequate information or analysis.

16. Most complex decisions depend on judgement, but the decisions of well-intentioned and experienced leaders can, in certain circumstances, be distorted. Factors known to distort judgement are conflicts of interest, emotional attachments, and inappropriate reliance on previous experience and previous decisions.

17. Boards can take steps to create the conditions for sound decision-making. Some chairs favour a series of separate discussions for important decisions; for example, concept, proposal for discussion, proposal for decision. This gives executive directors more opportunity to put the case at the earlier stages, and all directors the opportunity to share concerns or challenge assumptions well in advance of the point of decision.

18. Boards should invite relevant members of the executive team to explain the issues and implications before reaching a decision. Where more than one part of the business is affected, it should ensure it receives an integrated and joined-up information. The board should consider the potential impact of a decision on the company's culture, for example the behaviour it could drive or the message it might send. The board should ensure its decisions are consistent with its values and what the company says it stands for.

19. Where appropriate, the board should consider input from the workforce and other stakeholders and be able to explain how this was taken into account and the impact it had on the decision.

20. For significant decisions, a board may wish to consider extra steps, for example:

    - describing in board papers the process that has been used to arrive at and challenge the proposal prior to presenting it to the board, thereby allowing directors not involved in the project to assess the appropriateness of the process as a precursor to assessing the merits of the project itself;
    - where appropriate, putting in place additional safeguards to reduce the risk of distorted judgements by, for example, commissioning an independent report, seeking advice from an expert, introducing a devil's advocate to provide challenge, establishing a specific sub-committee, and convening additional meetings;
    - ensuring that board minutes document the details of the discussion that led to the decision including evidence of challenge.

21. Once a decision has been made and implemented the board should review the effectiveness of the decision-making process, and the merits of the decision itself.

RELATIONS WITH SHAREHOLDERS

22. The Code emphasises the importance of continual communication with major shareholders, and the importance of general meetings, as two aspects of a company's wider communications strategy. The chair should discuss governance and performance against the strategy with major shareholders and ensure that the views of shareholders are communicated to the board as a whole. When called upon, the senior independent director should seek to meet a sufficient range of major shareholders in order to develop a balanced understanding of their views. Non-executive directors should take opportunities such as attendance at general and other meetings to understand the concerns of shareholders.

23. The chairs of the audit, remuneration and nomination committees should be available to answer questions at the annual general meeting. The chair should encourage them to make a statement on the activities and achievements of the committee over the year. This could include details of engagement with shareholders on significant matters over the year.

24. The annual report is an important means of communicating with shareholders. They can also be used to provide well thought out disclosures on the company's governance arrangements and the board evaluation exercise. This can prompt reflection on the quality of governance, and ways to improve governance structures, processes and systems and, ultimately, the board's effectiveness.

25. The chair has a key role to play in representing the company to its principal audiences, and is encouraged to report personally in the Corporate Governance Statement in the annual report about board leadership and effectiveness.

RELATIONS WITH THE WORKFORCE AND WIDER STAKEHOLDERS

26. Companies need to respect a wide range of stakeholder interests and take account of the impact of their decisions on them. To do this directors must develop and maintain an understanding of the interests of these stakeholders.

27. Boards should start by identifying their different sets of stakeholders. This will include the workforce, customers, suppliers, which could be particular to the sector or location. Boards should seek input from these stakeholders to ensure they have a rounded view of how the company does business and the impact of its activities. In addition to formal and informal engagement with the workforce, possible sources of information might include:

    - Contacts with key customers
    - Customer complaints and satisfaction data
    - Supplier feedback
    - Social media
    - Contacts with interest groups and the local community

28. Directors also need to be able to articulate how they have taken account of the impact of the company's operations on a wider range of stakeholders and how these considerations have influenced their decision-making.

29. Directors may wish to refer to *The Stakeholder Voice in Board Decision Making* issued jointly by ICSA: The Governance Institute and the Investment Association for detailed guidance on how to build stakeholder considerations into board discussions.

30. Directors should be accountable by explaining their decisions and how they have taken account of the interests of different stakeholders. This will include being able to explain how the benefits in terms of the long-term success of the company outweigh any negative impacts, and any action the company plans to take to mitigate those impacts.

Gathering the views of the workforce

31. Communication between the workforce and the organisation is often referred to as the 'employee voice'. In practice, communication and engagement should involve the whole workforce not just employees. For example, remote workers, agency workers and contractors should be included in any engagement mechanisms that companies set up. As the workforce may have different interests it is therefore recommended that a broad cross-section of views be heard.

32. Having policies in place that encourage individuals to raise concerns is a core part of a supportive ethical business culture. Whistleblowing policies that offer effective protection from retaliation, as well as policies that support bribery and corruption legislation are essential components of this. Such policies are important, for example when attempts to resolve things internally have not worked.

33. It is equally important to create an environment that encourages individuals to raise concerns or ask questions about a wide range of issues. Speak up arrangements help build trust, and can act as an early warning system and help to manage risk. Some companies even extend such arrangements beyond the workforce to external parties, like customers and suppliers.

34. Engagement through a range of formal and informal channels helps the workforce to share ideas and concerns with senior management and the board, provides leaders with useful feedback about business practices from those delivering them and can help empower colleagues. Companies need to create an environment in which the workforce feel it is safe to voice their views. Common fears include being negatively labelled for speaking up, which might result in being side-lined for promotion, pay increases and bonuses. To be successful, leaders must actively listen, encourage the workforce to speak up and ensure there are no negative repercussions as a result of doing so.

35. With the aim of strengthening the 'employee voice' in the boardroom, the Code requires boards to establish a method for gathering the views of the workforce and suggests three ways this might be achieved: a director appointed from the workforce, a formal workforce advisory panel, or a designated non-executive director. These are not the only possible methods and boards should be open innovative alternatives if they believe these would be as or more effective. Boards may feel it would be most effective to adopt a combination of methods or multiple channels for engagement at different levels. Provided the method chosen delivers meaningful, regular two-way dialogue and a means of listening to the workforce, the Code requirement will be met.

Some examples of workforce engagement activities

- Director breakfasts
- Listening groups
- Focus or consultative groups
- Groups of elected workforce representatives
- Social media updates
- Employee AGMs
- Town halls and open door days
- Surveys
- Digital sharing platforms

36. A commonly used tool for capturing workforce sentiment is the annual engagement survey. These are sometimes supplemented by shorter 'pulse surveys' on specific issues. Surveys can be a powerful way to engage people and performing them regularly provides valuable trend data. While surveys are a useful source of information, an annual survey of the workforce will not, on its own, be a sufficient or reliable indicator of workforce views. It is important to establish a feedback loop following the survey so that the results are discussed with the workforce and there is transparency around actions to be taken to address the issues identified.

Questions for boards

- Is there a forum for employees to share ideas and concerns?
- How do we demonstrate we listen to the ideas and concerns from employees?
- Does management provide feedback to colleagues on how complaints and concerns have been dealt with?
- How comfortable do the workforce say they are with challenging and reporting issues of concern and is there any evidence that they are doing this?
- How do we explore culture in employee surveys?
- Do employees report that leaders and managers live the company's values?

CULTURE

37. Boards have a responsibility for the health of the company and need to take a longer-term view. This can be in contrast with some investors or potential investors who may focus on short-term returns.

38. Openness and accountability matter at every level of a company. Good governance means a focus on how this takes place throughout the company and those who act on its behalf. It should be demonstrated in the way the company conducts business, for example how it treats its workforce, customers and suppliers, and how it engages with and reports to stakeholders.

39. The board sets the framework within which a healthy corporate culture can develop, that underpins the way in which the company operates. It then satisfies itself that the culture throughout the organisation is consistent with that framework, leading by example and taking action where it spots misalignment.

40. Directors should be vigilant and watch out for signs of possible cultural problems such as those in Figure Two.

Figure Two – Tell-tale signs of a culture problem

- Silo thinking
- Dominant chief executive
- Leadership arrogance
- Pressure to meet the numbers/overambitious targets
- Lack of access to information
- Low levels of engagement between leadership and employees
- Lack of openness to challenge
- Poor succession planning
- Misaligned incentives and flawed executive remuneration practices
- Tolerance of regulatory or code of ethics breaches, e.g. by star employees
- A lack of diversity
- Hierarchical attitudes

Setting the Framework

41. Boards should start by determining the company's purpose and clearly defining a set of values that are aligned to that purpose and the company's strategy. Simply adopting a formal values statement is not enough. In order to have an impact on behavioural outcomes and influence the way business is done, values need to be embedded at every level of the organisation.

42. Boards should seek assurance that management has put appropriate mechanisms in place to implement and embed the company purpose, strategy and values. In particular, incentives and rewards, promotion and development decisions should be aligned to these. Boards should satisfy themselves that this is clear in company policies and is applied in practice, challenging themselves and management on how effective they are at shaping and embedding culture, for example in the areas suggested below.

Questions for boards

- Have we established values and made a public commitment to them?
- Have we translated the values into a set of behavioural expectations and has management communicated this widely and clearly across the company?
- How are we demonstrating ethical leadership, displaying and promoting throughout the company, behaviours we expect from others?
- How do we articulate and communicate what we consider to be acceptable business practices?
- Are we doing enough to test key decisions for alignment with values? Can we give examples of how key decisions reflect the values and explain how this was considered?
- What steps have we taken to address any negative trends or misalignment between values and behaviours?

Questions for boards to ask management

- Has management identified appropriate KPIs that are properly aligned to desired outcomes and behaviours?
- How have the values and behavioural expectations been reinforced in our recruitment, induction, performance management, incentives and reward policies, processes and practices?
- How are we testing this with new recruits and the existing workforce?
- What behaviours are being driven when setting strategy and financial targets?
- Is company tax policy consistent with stated values?
- What steps has management taken to ensure that suppliers meet expected standards of behaviour?

Monitoring culture

43. Boards should seek assurance about the health of the culture by taking the temperature in the organisation on a regular basis. This means gathering evidence by monitoring chosen indicators and assessing information from a range of company-specific sources to gain insights into the overall culture, capture information about individual sub-cultures and identify outliers. Where the board has concerns or finds misalignment it should make sure corrective action is taken.

44. The board should engage different parts of the business, for example HR, internal audit, risk and compliance, in its assessment of culture and encourage an integrated approach. It should make use of technology to access and analyse information in order to develop a more sophisticated view of culture-associated risk and develop its understanding of how culture and behaviours impact performance.

45. Boards need access to multiple sources of information about how the organisation operates. While non-executive directors need to maintain independence, they also need to understand the views of the workforce, to get a feel for the culture of the organisation.

Some sources of culture insights

- Turnover and absenteeism rates
- Training data
- Recruitment, reward and promotion decisions
- Grievance and 'speak up' data
- Poor compliance, e.g. health and safety incidents
- Regulatory and ethics breaches
- Promptness of payments to suppliers
- Attitudes to regulators, internal audit and employees

46. Non-executive directors, and in particular chairs, can consider ways of reaching out to the workforce, such as:

- Spending more time in the business
- Talking to frontline and supervisory colleagues
- Listening to workforce anecdotes and personal observations
- Hosting town halls
- Inviting a wider range of business functions and colleagues to attend board meetings
- Meeting with future leaders without senior management
- Visiting regional or overseas sites
- Establishing mentoring between non-executive directors and middle managers

What are we monitoring?

- What indicators of culture are we monitoring and have we established appropriate benchmarks against which to assess culture?
- How are we using technology to measure behavioural/cultural indicators?
- What other sources are we using to gain insights into culture and how things are done?
- Is management using root cause analysis when things go wrong? (Examining not just what went wrong but why.) For example, were incentives/rewards, social or power dynamics a contributing factor?
- Is the company holding exit interviews with leavers and are we considering how the feedback reflects on the company's culture?

Are we making the most of our internal capabilities?

- Is internal audit sufficiently highly valued within the organisation, does it have the degree of independence needed and a clear mandate to look at culture?
- Do we need to invest in internal audit and develop the skills base and capabilities or encourage the use of multi-disciplinary teams?
- What more could we do to ensure internal audit, HR, compliance and risk work collaboratively and report jointly to help us draw insights into culture?
- What assurance do we have that the code of conduct and ethics training programmes are up to date, adequately communicated and understood by the workforce?

What evidence are we looking for?

- What evidence is there that the way the company conducts business *in practice* is consistent with what it claims to stand for?
- Are we seeing evidence of sub-cultures or pockets of autonomy in the business that could undermine the overall culture?
- Do employees feel that customers and suppliers are treated fairly and that the company cares about its impact on the environment and community?
- What evidence do we have that the chief executive is willing to listen, take criticism and let others make decisions?
- How does the 'tone in the middle' resonate with the workforce?
- How does the company deal with breaches of company rules or codes of conduct?
- What action do we take against senior people or star performers who do not uphold the company's values?
- What do examples of communications from leadership and middle management tell us about the commitment to values, openness and accountability?

2. DIVISION OF RESPONSIBILITIES

47. All directors should uphold the highest standards of integrity and probity and support the chair in instilling the appropriate culture, values and behaviours in the boardroom and beyond.

THE ROLE OF THE CHAIR

48. The chair is responsible for leadership of the board and for ensuring it is effective. They should set clear expectations concerning the company's culture, values and behaviours, and the style and tone of board discussions.

49. The chair is pivotal in creating the conditions for overall board and individual director effectiveness and should make certain that the board has effective decision-making processes and applies sufficient challenge to major proposals. The chair should make certain that all directors are aware of their wider responsibilities when joining the board. The chair should hold meetings with the non-executive directors without the executives present to facilitate a full and frank airing of views.

50. The chair's role includes:

- setting a board agenda which is primarily focused on strategy, performance, value creation and accountability, and ensuring that issues relevant to these areas are reserved for board decision;
- ensuring that adequate time is available for discussion of all agenda items, in particular strategic issues;
- ensuring a timely flow of accurate, high-quality and clear information;
- making certain that the board determines the nature, and extent, of the significant risks the company is willing to embrace in the implementation of its strategy;
- encouraging all board members to engage in board and committee meetings by drawing on their skills, experience, knowledge and, where appropriate, independence;
- fostering relationships founded on mutual respect and open communication – both in and outside the boardroom – between the non-executive directors and the executive team;
- developing productive working relationships with all executive directors, and the chief executive in particular, providing support and advice while respecting executive responsibility;
- ensuring all directors receive a full, formal and tailored induction on joining the board;
- undertaking regular reviews and agreeing development needs with each director to ensure they continually update their skills, knowledge and familiarity with the company required to fulfil their role both on the board and on committees;
- leading the annual board evaluation, with support from the senior independent director as appropriate, and acting on the results; and
- ensuring the board listens to the views of shareholders, the workforce and other stakeholders.

Board committees

51. While the board may make use of committees to assist its consideration of appointments, succession, audit, risk and remuneration, it retains responsibility for, and makes final decisions on, all of these areas. The chair should ensure that sufficient time is allowed at the board for committees to report on the nature and content of discussion, on recommendations, and on actions to be taken.

52. The chair should ensure the board's committees are properly structured with appropriate terms of reference. They should ensure that committee membership is periodically refreshed and that undue reliance is not placed on a small number of independent non-executive directors when deciding the chairs and membership of committees.

53. The chair of each committee fulfils an important leadership role similar to that of the chair of the board, particularly in creating the conditions for overall committee and individual director effectiveness. They should make available the terms of reference, explaining the role of the committee and the authority delegated to it by the board on the company website.

54. No one other than the committee chair and members is entitled to be present at a meeting, but others may attend at the invitation of the committee.

55. The minutes of committee meetings should be circulated to all board members, unless it would be inappropriate to do so, and to the company secretary (if he or she is not secretary to the committee). The remit of each committee, and the processes of interaction between committees and between each committee and the board, should be reviewed regularly.

THE ROLE OF THE SENIOR INDEPENDENT DIRECTOR

56. In normal times the senior independent director should act as a sounding board for the chair, providing them with support in the delivery of their objectives and leading the evaluation of the chair on behalf of the other directors. The senior independent director might also take responsibility for an orderly succession process for the chair, working closely with the nomination committee.

57. The senior independent director should also be available to shareholders if they have concerns which contact through the normal channels of chair, chief executive or other executive directors has failed to resolve or for which such contact is inappropriate.

58. When the board or company is undergoing a period of stress the senior independent director's role becomes critically important. They are expected to work with the chair and other directors, and/or shareholders, to resolve significant issues. Boards should ensure they have a clear understanding of when the senior independent director might intervene in order to maintain board and company stability. Examples might include where:

    - there is a dispute between the chair and chief executive;
    - shareholders or non-executive directors have expressed concerns that are not being addressed by the chair or chief executive;
    - the strategy being followed by the chair and chief executive is not supported by the entire board;
    - the relationship between the chair and chief executive is particularly close, and decisions are being made without the approval of the full board; or
    - succession planning is being ignored.

    These issues should be considered when defining the role of the senior independent director, which should be set out in writing.

THE ROLE OF EXECUTIVE DIRECTORS

59. Executive directors have the same duties as other members of a unitary board. These duties extend to the whole of the business, and not just that part of it covered by their individual executive roles. Nor should executive directors see themselves only as members of the chief executive's team, when engaged in board business. Taking the wider

view can help achieve the advantage of a unitary system: greater knowledge, involvement and commitment at the point of decision. Executive directors are likely to be able to broaden their understanding of their board responsibilities if they take up a non-executive director position on another board.

60. The chief executive is the most senior executive director with responsibility for proposing company strategy and for delivering the strategy as agreed by the board. The chief executive's relationship with the chair is a key relationship that can help the board be more effective. The Code states that the differing responsibilities of the chair and the chief executive should be set out in writing and agreed by the board. Particular attention should be paid to areas of potential overlap.

61. With the support of the executive team, the chief executive has primary responsibility for setting an example to the company's employees, and communicating to them the expectations of the board in relation to the company's culture: its values, attitudes and behaviours. They are responsible for supporting the chair to make certain that appropriate standards of governance permeate through all parts of the organisation, and will support the board in establishing a method for gathering the views of the workforce. They will also ensure the board is made aware of views gathered via other forms of engagement between management and the workforce.

62. It is the responsibility of the chief executive to ensure the board knows the views of the senior management on business issues in order to improve the standard of discussion in the boardroom and, prior to final decision on an issue, explain in a balanced way any divergence of view in the executive team.

63. The chief executive is also responsible for ensuring that management fulfils its obligation to provide board directors with:

    - accurate, timely and clear information in a form and of a quality and comprehensiveness that will enable it to discharge its duties;
    - the necessary resources for developing and updating their directors knowledge and capabilities; and
    - appropriate knowledge of the company, including access to company operations and members of the workforce.

64. Executive directors have a greater knowledge of the company and its capabilities. They should appreciate that constructive challenge from non-executive directors is an essential aspect of good governance, and should encourage their non-executive colleagues to test their proposals in the light of the non-executives' wider experience outside the company. The chair and the chief executive should ensure that this process is properly followed.

THE ROLE OF NON-EXECUTIVE DIRECTORS

65. Non-executive directors should, on appointment, devote time to a comprehensive, formal and tailored induction which should extend beyond the boardroom. Initiatives such as partnering a non-executive director with an executive board member may speed up the process of him or her acquiring an understanding of the main areas of business activity, especially areas involving significant risk. They should expect to visit operations and talk with senior and middle managers in these areas and should talk with non-managerial members of the workforce. The non-executive director should use these conversations to get a feel for the culture of the organisation and the way things are done in practice and to gain insight into the experience and concerns of frontline workers.

66. It is vital that non-executive directors make sufficient time available to discharge their responsibilities effectively. They should devote time to developing and refreshing their knowledge and skills, including those of communication, to ensure that they continue to make a positive contribution to the board. Being well-informed about the company, and having a strong command of the relevant issues, will generate the respect of the other directors.

67. Non-executive directors should insist on receiving high-quality information sufficiently in advance so that there can be thorough consideration of the issues prior to, and informed debate and challenge at, board meetings. They should expect this information to:

    - be accurate, clear, comprehensive and up-to-date;
    - contain a summary of the contents of any paper; and
    - inform the director what is expected of them on that issue.

    Non-executive directors should seek clarification or amplification where they consider the information provided is inadequate or lacks clarity.

68. To fulfil their duties, non-executive directors should take into account the views of shareholders, the workforce and other stakeholders, because these views may provide different perspectives on the company and its performance. They should avail themselves of opportunities to meet major shareholders, key customers and members of the workforce from all levels of the organisation.

BOARD SUPPORT AND THE ROLE OF THE COMPANY SECRETARY

69. The company secretary is responsible to the board for ensuring that board procedures are complied with, advising the board on all governance matters, and should support the chair and help the board and its committees to function efficiently.

70. Under the direction of the chair, the company secretary's responsibilities include ensuring good information flows within the board and its committees and between senior management and non-executive directors, as well as facilitating induction and assisting with professional development as required. They should arrange for the company to provide the necessary resources for developing and updating its directors' knowledge and capabilities. This should be in a manner that is appropriate to the particular director, and which has the objective of enhancing that director's effectiveness in the board or board committees, consistent with the results of the board's evaluation processes.

71. It is the responsibility of the company secretary to 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 of the company. Committees should be provided with sufficient resources to undertake their duties.

72. The company secretary should report to the chair on all board governance matters. This does not preclude the company secretary also reporting to the chief executive in relation to their other executive management responsibilities. The remuneration of the company secretary should be determined by the remuneration committee.

73. Assisting the chair in establishing the policies and processes the board needs in order to function properly is a core part of the company secretary's role. The chair and the company secretary should periodically review whether the board and the company's other governance processes, for example board and committee evaluation, are fit for purpose,

and consider any improvements or initiatives that could strengthen the governance of the company.

74. The company secretary's effectiveness can be enhanced by building relationships of mutual trust with the chair, the senior independent director and the non-executive directors, while maintaining the confidence of executive director colleagues. They are in a unique position between the executive and the board and well placed to take responsibility for concerns raised by the workforce about conduct, financial improprieties or other matters.

3. COMPOSITION, SUCCESSION AND EVALUATION

ROLE OF THE NOMINATION COMMITTEE

75. The nomination committee should be responsible for board recruitment. The process should be continuous and proactive, and should take into account the company's agreed strategic priorities. The aim should be to secure a boardroom which achieves fresh input and thinking, and the right balance between challenge and teamwork, while maintaining a cohesive board.

76. The nomination committee should be clear about the values and behaviours expected when recruiting new directors and senior management and build a proper assessment of this into the recruitment process. It should evaluate the balance of skills, experience, knowledge and diversity on the board and, in the light of this evaluation, prepare a description of the role and capabilities required for a particular appointment. This should include an assessment of the time commitment expected, recognising the need for availability in the event of crises.

77. The terms and conditions of appointment of non-executive directors, including the chair, should be made available on the company website. Letters of appointment should set out the expected time commitment and also indicate the possibility of additional commitment when the company is undergoing a period of particularly increased activity, such as an acquisition or takeover, or as a result of some major difficulty with one or more of its operations.

78. Chairs and 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. Changes to such commitments should be approved by the board as they arise. The other commitments of the chair and any impact arising from changes to those commitments should be explained in the annual report. Taking account of the respective time commitments involved, the nomination committee may wish to consider whether to set an upper limit on the number of other non-executive appointments it considers the chair and other non-executives may take on without compromising their effectiveness.

79. Appointing directors who are able to make a positive contribution is one of the key elements of board effectiveness. Directors will be more likely to make good decisions and maximise the opportunities for the company's success in the longer term if the right skill-sets and a breadth of perspectives are present in the boardroom. This includes independence of mind, diversity and a range of skills, experience and knowledge. Non-executive directors should all possess critical skills of value to the board and relevant to the challenges and opportunities facing the company.

80. There is considerable evidence that diversity in the boardroom has a positive effect on the quality of decision-making and company performance. Nomination committees should take positive steps to increase levels of diversity both at board-level and in the executive pipeline. Building the executive pipeline is vital to progress and to increase levels of diversity amongst those in senior positions.

81. The nomination committee should take an active role in setting and meeting diversity objectives and strategies for the company as a whole and in monitoring the impact of diversity initiatives. Examples of the type of actions the nomination committee could consider encouraging include:

- a commitment to increasing the diversity of the board by setting stretching targets;
- dedicated initiatives with clear objectives and targets, for example in areas of the business that lack diversity;
- mentoring and sponsorship schemes;
- a commitment to more diverse shortlists and interview panels; and
- positive action to encourage more movement into non-traditional roles, for example women in finance.

82. It is important to consider a diversity of personal attributes among board candidates, including intellect, critical assessment and judgement, courage, openness, honesty and tact; and the ability to listen, forge relationships and develop trust. Diversity of psychological type, background, gender and ethnicity is important to ensure that a board is not composed solely of like-minded individuals. A board requires directors who have the intellectual capability to suggest change to a proposed strategy, and to promulgate alternatives.

83. Given the importance of committees in many companies' decision-making structures, it will be important to recruit non-executive directors with the necessary technical skills and knowledge relating to the committees' subject matter, as well as the potential to assume the role of committee chair.

SUCCESSION PLANNING

84. The chair's vision for achieving the optimal board composition will help the nomination committee review the skills required, identify the gaps, develop transparent appointment criteria and inform succession planning. The nomination committee should periodically assess whether the desired outcome has been achieved, and propose changes to the process as necessary. There are risks of becoming too reliant on the skills of one individual. Discussions on tenure at the time of appointment will help to inform and manage the long-term succession strategy. Board effectiveness and succession should be discussed with shareholders.

85. Executive directors may be recruited from external sources, but companies should also develop internal talent and capability. Initiatives might include middle management development programmes, facilitating engagement from time to time between middle management and non-executive directors, as well as partnering and mentoring schemes.

86. Talent management can be a strong motivational force for those who wish to develop their career within the company and achieve senior positions and can provide the nomination committee with a variety of strong candidates. Nomination committees should consider taking a more active interest in how talent is managed throughout the organisation.

87. Good board appointments do not depend only on the nomination committee. A prospective director should carry out sufficient due diligence to understand the company and its culture, appreciate the time commitment involved, and assess the likelihood that they will be able to make a positive contribution.

Succession plans should consider different time horizons

- contingency planning – for sudden and unforeseen departures;
- medium-term planning – the orderly replacement of current board members and senior executives (e.g. retirement); and
- long-term planning – the relationship between the delivery of the company strategy and objectives to the skills needed on the board now and in the future.

88. More consideration should be applied to the nature, variety and frequency of interaction between the board and aspiring board candidates at varying levels of management.

89. Boards as a whole should be better informed about the link between diversity, strategy and business value. Diversity should be regarded as a broad concept in order to encourage diverse thinking and to avoid the dangers of 'group think'. Succession plans should include objectives to increase diversity in the boardroom and build diversity in the executive pipeline.

EVALUATING THE PERFORMANCE OF THE BOARD AND DIRECTORS

90. Boards continually need to monitor and improve their performance. This can be achieved through board evaluation, which provides a powerful and valuable feedback mechanism for improving board effectiveness, maximising strengths and highlighting areas for further development. The evaluation process should aim to be objective and rigorous.

91. Like induction and board development, evaluation should be bespoke in its formulation and delivery. The chair has overall responsibility for the process, and should select an appropriate approach, involving the senior independent director as appropriate. The senior independent director should lead the process which evaluates the performance of the chair and in some circumstances may lead the entire evaluation process. The chair should consider how to obtain input from the workforce and other stakeholders on the board's performance. Chairs of board committees should be responsible for the evaluation of their committees.

92. Board evaluations should inform and influence succession planning. They are an opportunity for boards to assess their composition and agree plans for increasing diversity. They also help companies identify when new board appointments may be needed and the types of skills that are required to maximise board effectiveness.

93. The chair is responsible for acting on the outcome of the board evaluation, which should also be shared with the whole board as appropriate. The outcome should be fed back into the board's work on composition, the design of induction and development programmes, and other relevant areas. It may be useful for a company to have a review loop to consider how effective the board evaluation process has been and how well the outcome has been acted upon. The chair is encouraged to give a flavour of the board evaluation process in their statement in the annual report.

94. The Code recommends that premium-listed companies have externally-facilitated board evaluations at least every three years. External facilitation can add value by introducing a fresh perspective and new ways of thinking. It may also be useful in particular circumstances, such as when there is a new chair, if there is a known problem around the board table requiring tactful handling; or there is an external perception that the board is, or has been, ineffective. The chair should consider with the external facilitator whether it would be appropriate to obtain feedback from the workforce and other stakeholders on the performance of the board and individual directors.

95. Whether facilitated externally or internally, evaluations should explore how effective the board is as a unit, as well as the quality of the contributions made by individual directors. Some areas which may be considered, although they are neither prescriptive nor exhaustive, include:

- the mix of skills, experience, knowledge and diversity on the board, in the context of the challenges and opportunities facing the company;
- clarity of, and leadership given to, the purpose, direction and values of the company;
- succession and development plans;
- how the board works together as a unit, and the tone set by the chair and the chief executive;
- key board relationships, particularly chair/chief executive, chair/senior independent director, chair/company secretary and executive/non-executive;
- effectiveness of individual non-executive and executive directors;
- clarity of the senior independent director's role;
- effectiveness of board committees, and how they are connected with the main board;
- quality of the general information provided on the company and its performance;
- quality of papers and presentations to the board;
- quality of discussions around individual proposals;
- process the chair uses to ensure sufficient debate for major decisions or contentious issues;
- effectiveness of the company secretary/secretariat;
- clarity of the decision processes and authorities;
- processes for identifying and reviewing risks; and
- how the board communicates with, and listens and responds to, shareholders and other stakeholders.

4. AUDIT, RISK AND INTERNAL CONTROL

96. While the board may make use of committees to assist its consideration of audit and risk, it retains responsibility for, and makes the final decisions on, all of these areas. The chair should ensure that sufficient time is allowed at the board for discussion of these issues. All directors should familiarise themselves with the relevant Principles and Provisions of the Code, the related Guidance on Audit Committees and Guidance on Risk Management, Internal Control and Related Financial and Business Reporting, and any relevant regulatory requirements.

97. Where requested by the board, the audit committee should provide advice on whether the annual report and accounts, taken as a whole, is fair, balanced and understandable and provides the information necessary for shareholders to assess the company's position and performance, business model and strategy.

Viability Statements

98. The period selected for the viability statement often appears to be based on the company's medium-term business plan. However, the *Guidance on Risk Management, Internal Control and Related Financial and Business Reporting* suggests that other factors should be taken into account, for example investment and planning periods, the board's stewardship responsibilities, the nature of the business and its stage of developments and previous statements made, especially in raising capital.

99. The factors considered will clearly depend on the circumstances and maturity of the relevant company and the industry that it operates in. Industries such as mining and property investment companies typically have longer term investment strategies and funding arrangements. Companies should tailor their approach to their specific circumstances and planning cycles.

100. Companies should consider developing their viability statements in two stages, firstly by considering and reporting on their longer-term prospects taking into account the company's current position and principal risks, and then by stating whether they have a reasonable expectation that the company will be able to continue in operation and meet its liabilities as they fall due over the period of their viability assessment, drawing attention to any qualifications or assumptions as necessary.

101. Good practice examples clearly explain the underlying analysis that support the statement. They should also include proper explanation of how the company has carried out its analysis.

5. REMUNERATION

OVERSIGHT OF WORKFORCE PAY, CONDITIONS AND POLICIES

102. The board has ultimate responsibility for ensuring workforce remuneration, incentives and other workforce policies support the long-term success of the company and promote its values.

103. This means overseeing not only pay, conditions and incentives but also other policies that have an impact on the experience of the workforce and drive behaviours. This includes policies around recruitment and retention, promotion and progression, performance management, training and development, reskilling and flexible working.

104. Boards can choose to delegate responsibility for overseeing wider workforce remuneration, incentives and workforce policies to the remuneration committee or, where appropriate, another committee with relevant responsibilities, for example, a sustainability committee or a corporate responsibility committee. Where the board elects to do this it should ensure the committees adopt an integrated approach that joins up oversight of wider workforce pay and policies with the remuneration committee's consideration of executive remuneration.

105. On workforce pay, one approach might be for the board or its delegated committee to review and endorse clear principles for pay and reward across the organisation and satisfy itself that management implements these properly and that incentives drive behaviour consistent with values. Examples of reward principles companies might consider include equal pay, security, predictability of income, market competitiveness and reward for contribution. Boards can then establish a baseline and monitor application of the principles and progress towards objectives.

106. Boards can act as a unifying focal point on workforce matters that has the potential to help companies join up the different aspects of their overall workforce value proposition, ensure the workforce feels it has had a say on matters that affect it and explain what it has to offer current and prospective workers.

Possible questions for boards

- How well are our values and expected behaviours embedded in all our HR processes from recruitment to exit interviews?
- How does the company structure remuneration and other forms of reward to produce appropriate incentives?
- Have we established clear principles for pay across the organisation against which we can justify and benchmark pay policies and outcomes?
- Can we articulate our approach to investing in and rewarding our workforce? Have we taken workforce views and priorities into account in developing our approach?
- Does the balance between financial and non-financial incentives support the desired culture?
- Are behavioural objectives included in leadership and employee goals and are behaviours formally assessed as part of performance review activity?
- Have we considered whether executive pay incentives or those of other employees could undermine culture?
- What are we doing to address gender pay gaps?

ROLE OF THE REMUNERATION COMMITTEE

107. The remuneration committee has delegated responsibility for designing and determining remuneration for executive directors, the chair and the next level of senior management. It should ensure that potential conflicts are recognised and managed and that no individual is involved in decisions relating to their own remuneration.

108. The remuneration committee should consider executive remuneration in the context of the approach to pay and conditions applied across the company's workforce as a whole and ensure that the total rewards potentially available are not excessive. They should avoid designing pay structures based solely on benchmarking to the market or the advice of remuneration consultants.

109. It is vital that the remuneration committee is alive to the risk of incentives encouraging behaviours that are to the long-term detriment of the company and should consider ways to counteract this, for example the build-up of significant shareholdings for the long-term. Packages that are structured to ensure exposure to the long-term share price over five to seven years and for two to three years after leaving the company can support alignment with shareholders. Releasing shares for sale on a phased basis rather than block release, e.g. on retirement or on leaving the company, can also encourage a focus on sustainable performance.

110. The Code requires remuneration schemes to provide discretion to override formulaic outcomes. The remuneration committee should ensure it recommends adjusting pay awards where the outcome otherwise will not be aligned to individual performance or will not deliver the policy intentions. For example to take account of share price growth, the impact of a share repurchase scheme or a government support initiative. This should be clearly disclosed. The remuneration committee should consider whether a cap on executive rewards is appropriate and be prepared to explain the rationale behind its decision.

111. Under the Code, schemes must also include malus and clawback provisions in certain specified circumstances. Such circumstances might include payments based on erroneous or misleading data, misconduct and misstatement of accounts.

112. Packages should not reward poor performance. Compensation commitments due to directors under their terms of appointment in the event of loss of office should be proportionate and variable by discretion. The remuneration committee should vary compensation where appropriate to the circumstances and to reflect departing directors' conduct and performance. They should reduce compensation to reflect departing directors' obligations to mitigate loss.

113. The remuneration committee should engage with the workforce to explain how executive remuneration aligns with wider company pay policy and promotes long-term value generation. This may involve using pay ratios to help explain the approach where appropriate. It may also involve explaining the rationale behind the structure and metrics chosen, any principles that have been applied to remuneration, factors that have been considered in setting executive remuneration and the circumstances in which discretion will need to be when determining pay outcomes.

Questions for remuneration committees

- How is executive remuneration aligned with wider company pay policy?
- How is corporate reputational risk considered in the setting of incentive pay?
- In what circumstances would we expect to exercise discretion over remuneration outcomes?
- What is the maximum award we think is reasonable for our executive directors and what will we do in the event the application of the formula produces an outcome in excess of that award?
- How does executive remuneration link to our strategy and KPIs?
- How effective are the financial and non-financial performance measures at supporting values and culture?
- Are incentives across the organisation aligned to our culture and encouraging the desired behaviours?
- Have we considered negative behaviour which the choice of any particular metric may encourage and what steps have we taken to manage such risks?
- Do employees feel that they are treated well and fairly in the workplace and that they are supported in developing themselves and fulfilling their potential?
- What have we done to explain executive pay arrangements in comparison with those of the workforce?

APPENDIX

OTHER SOURCES OF INFORMATION

FRC Papers

- Guidance on Risk Management, Internal Control and Related Financial and Business Reporting
- Guidance on Audit Committee
- Corporate Culture and the Role of Boards
- The UK Stewardship Code – sets out good practice for institutional investors on engaging with the companies in which they invest.

These can be downloaded from the FRC website: www.frc.org.uk or obtained free of charge from FRC Publications via the following methods:

Telephone: 020 8247 1264
Email: customer.services@cch.co.uk
Online: www.frcpublications.com

Directors' Duties

The legal duties of directors of UK companies are set out in Sections 170 to 177 of the Companies Act 2006, which is available at: www.legislation.gov.uk/ukpga/2006/46/contents

Other sources of guidance

Note: this is not a comprehensive list as other sources of information and advice are available.

The Institute of Chartered Secretaries and Administrators provides guidance on a wide range of board-related matters, for example, specimen terms of reference for board committees. This guidance can be found at: www.icsa.org.uk/policy-guidance

The Institute of Directors provides a wide range of guidance notes for directors, which are available at: www.iod.com/Home/Business-Information-and-Advice/Being-a-Director/

Smaller listed companies may find the guidance produced by the Quoted Companies Alliance useful. This can be found at: http://www.theqca.com/shop/guides/

ICSA: The Governance Institute and the Investment Association guidance, *The Stakeholder Voice in Board Decision Making* (published Sept. 2017) is available from: www.icsa.org.uk/assets/files/free-guidance-notes/the-stakeholder-voice-in-Board-Decision-Making-09-2017.pdf

Institute of Business Ethics guidance, *Encouraging a Speak-Up Culture* (published Nov. 2017) a summary is available: www.ibe.org.uk/userassets/pubsummaries/summ_gpg_speakup2.pdf

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