2 PRINCIPLES OF CORPORATE GOVERNANCE

2.1 We draw a distinction between principles of corporate governance and more detailed guidelines like the Cadbury and Greenbury codes. Witb guidelines, one asks 'How far are they complied with?'; with principles, the right question is 'How are they applied in practice?'. We recommend that companies should include in their annual report and accounts a narrative statement of how they apply the relevant principles to their particular circumstances. Given that the responsibility for good corporate governance rests with the board of directors, the written description of the way in which the board has applied the principies of corporate governance represents a key part of the process. We do not prescribe the form or content of this statement, which could conveniently be linked with the compliance statement required by the Listing Rules.

2.2 Against this background, we believe that the following principles can contribute to good corporate governance. They are developed further in later chapters.

A Directors

I **The Board. Every listed company should be headed by an effective board which should lead and control the company.**

2.3 This follows Cadbury (report, paragraph 4.1). It stresses the dual role of the board — leadership and control — and tbr need to be effective in both. It assumes the unitary board almost universal in UK companies.

II **Chairman and Chief Executive Officer. There are two key tasks at the top of every pblic company — the running of the board and the executive responsibility for the running of the company's business. A decision to combine these roles in one individual should be publicly explained.**

2.4 This makes it clear that therc are two distinct jobs, that of the chairman of the hoard and that of the chief executive officer. The question whether the holder should be the same person is discussed below (3.16-3.18).

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

2.5 Cadbury highlights the need to avoid the board being dominated by one individual (code 1.2). This risk is greatest where the roles of chairman and chief executive officer are combined. But whether or not the two roles are separated, it is important that there should be a sufficient number of non-executive directors, a majority of them independent and seen to be independent; and that these individuals should be able both to work co-operatively with their executive colleagues and to demonstrate objectivity and robust independence of judgement when necessary.

IV **Supply of Information. The board should be supplied in a timely fashion with information in a form aud of a quality appropriate to enable it to discharge its duties.**

2.6 We endorse the view of the Cadbury committee (report, 4.14) that the effectiveness of non-executive directors (indeed, of al1 directors) turns, to a considerable extent, on the quality of the information they receive.

V Appointments to the Board. There should be a formal aud transparent procedure for the appointment of new directors **to the board.**

2.7 The Cadbury committee commended the establishment of uomination committees but did not include them in the Code of Practice. In our view adoption of a formal

procedure for appointments to the board, with a nomination committee making recommcndations to the full **board,** should be recognised as good practice.

VI Re-election. All directors should be required to submit **themselves for re-election at regular intervals and at least every three years.**

2.8 Wc endorse thr view that it is the board's responsibility to appoint ncw directors and the shareholders' responsibility to re-elect them.The "insulation" of directors from re-elcction is dying out and we consider that it **should now** cease. This will promote cffective boards and recognise shareholders' inherent rights.

B Directors' Remuneration

2.9 Directors' rcmuneration should be embraced in the corporate governance process; the way in which directors' remuneration is handled can have a damaging effect on a company's public reputation, and on morale within the company. We suggcst thc following bread principles.

I The Level and Make-up of Remuneration. **Levels of remuneration should be sufficient to attract and retain the directors needed to run the company successfully. The component parts of remuneration should be structured so as to link rewards to corporate and individual performance.**

2.10 This wording makes it clear that those responsible should consider the remuneration of each director individually, and should do so against the needs of the particular company for talcnt at board level at the particular time. The remuneration of executive directors should be linked to performance.

II **Procedure.** Companies should establish a formal and transparent procedure for developing policy on executive remuneration and for fixing the remuneration packages of individual executive directors.

2.11 Cadbury and Greenbury both favoured the establishment of rcmuneration committees, and made recommcndations on their composition and on the scope of their rrmit. Thr remoneration committee is responsible to the board who have final responsibility for rcmuneration policy. But directors, whethcr executive or non-exrcutivr, should not participate in thr decisions on their own remuneration packagcs.

III **Disclosure.** The company's annual report should contain a statement of remuneration policy and details of the remuneration of each director.

2.12 This follows Greenbury (code B.l) except that it implies that the report would be in the name of the board, rather than of thc remuneration committee. This is in line with our view that remuneration policy, as distinct from decisions on individual remuneration packages for executive directors, should be a matter for the board (see 4.12).

C Shareholders

2.13 This section includes principles for applicatian both by listed companies and by shareholders.

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

2.14 Institutional shareholders include intrrnally managed pcnsion funds, insurance companies and professional fund managcrs. Thr wording does not make voting mandatory, i.e. abstention rcmains en option; bnt thcsc shareholdcrs should, as a mattcr of practicc, make considered use of their votes.

II **Dialogu e between Companies and Investors.** Companies and institutional sbarebolders sbould eacb be ready, where practicable, to enter into a dialogue based on the mutual understanding of objectives.

2.15 This gives general endorsement to the idea of dialogue between companies and major investors. In practice, both companies and institutions can only participate in a limited number of one-to-one dialogues.

III **Evaluation of Governance Disclosnres.** When evaluating companies' governance arrangements, particularly those relating to board structure and composition, institntional investors and their advisers should give due weight to al1 relevant factors drawn to their attention.

2.16 This follows from the discussion in Chapter 1, paragraphs 1.11-1.14 on the importance of considering disclosures on their individual merits, as opposed to 'box ticking'.

IV **The AGM.** Companies should use the AGM to communicate with private investors and enconrage their participation.

2.17 Private investors hold about 20% of the shares in listed companies, but are able to make little contribution to corporate governance The main way of achieving greater participation is through improved use of the AGM. Wc discuss a numbcr of suggestions for this purpose later.

D Accountability and Audit

2.18 **This section includes principles for application both by listed companies and by auditors.**

I **Financia1 Reporting. The board should present a balanced and understandable assessment of the company's position and prospects.**

2.19 **This follows thc Cadbury Code (4.1). It is not limited to the statutory obligation to produce financia1 statements. The wording rcfers mainly to the annual report to shareholders, but the principie also covers interim and other price-sensitive public reports and reports to regulators.**

II **Internal Control. The board should maintain a sound systern of interna1 control to safeguard shareholders' investment and the company's assets.**

2.20 **This covers not only financia1 controls but operational and compliance controls, and risk management, since there are potential threats to shareholders' investment in each of these areas.**

III **Relationship with the Auditors. The board should establish formal and transparent arrangements for maintaining an appropriate relationship with the company's auditors.**

2.21 **We support thr Cadbury recommendation (report, 4.35(a) and (b)) that al1 listed companies should establish an audit committee, composed of non-executive directors, as a committer of, and responsible to, the board. The duties of the audit committee include keeping under revicw thc scope and results of the audit and its cost-effectiveness, and the independence and objectivity of thc auditors.**

IV **External** Auditors. The external auditors should **independently report to shareholders in accordance with statutory and professional requirements and independently assure the board on the discharge of** its responsibilities under **D.I and D.11 above in** accordance with professional guidance.

2.22 This points up the dual responsibility of the auditors — the public report to shareholders on the statutory financial statements and on other matters as required by the Listing Rules; and additional private reporting to directors on operational and other matters.