

Corporate Governance

This paper (based on material prepared by the Department of Trade and Industry) forms a brief explanatory note, setting out:

- what corporate governance is;
- the key role played by the Board; and
- examples of some of the corporate governance frameworks used by listed companies and government owned entities.

What is it?

Corporate governance is the system by which companies are directed and controlled. It provides 'an architecture of accountability – the structures and processes to ensure companies are managed in the interests of their owners'.¹

The Role of the Board

The Board and its Directors

- Vital to the success of the company is an effective board that not only provides entrepreneurial leadership, but also ensures that effective controls are in place to manage risks.
- In order to do this, the board needs to be balanced in terms of the representation of executive, non-executive, and independent non-executive directors; this also avoids concentrations of power and encourages balanced decision-making. In order to fulfil their roles effectively, all directors clearly need to possess the appropriate skills and knowledge, which should be regularly evaluated and updated. In this context, independent non-executive directors are independent from the management and from any other relationship that could affect the exercise of impartial judgment.
- For the key areas involving conflicts of interest, the board should to establish sub-committees covering nomination, remuneration and audit which will report and make proposals to the main board for its approval.

The Board and its Shareholders

- The board also needs to interact effectively with shareholders: transparency and accountability are the watchwords. The most important elements to this are the timely provision of good quality information, thus promoting an informed dialogue and a credible decision-making process.
- In their turn, the shareholders should devote sufficient time and give effective consideration to the information they are provided with and the judgements they need to make in the decision-making process.

The Listed Companies Framework

- The corporate governance framework operates at a number of levels. There are some areas where, for example, Parliament or the Financial Services Authority (via the Listing Rules) have decided that it is appropriate to impose requirements on companies.

¹ *Review of the role and effectiveness of non-executive directors*, D Higgs (2003)

- However, there is also widespread agreement that there is an important role for a generally accepted code of best practice and the Combined Code has fulfilled this role since 1998.

The Combined Code

- The Combined Code is the Financial Reporting Council's Code of Corporate Governance. It contains general principles and more detailed provisions relating to the corporate governance of listed companies.
- Such companies must include in their annual reports how they apply the Code's principles or comply with its provisions. Where they do not comply, they must provide an explanation: hence the 'comply or explain' principle, which, if applied effectively, underpins an informed dialogue between directors and shareholders.

A comparison of primary shareholder models is at Annex A.

The Government Shareholder Model

Set out below is the regime applying to companies, eg the Post Office, where the Government is shareholder (though this should not be taken to imply a view that a similar regime would necessarily be applicable in the case of the BBC).

Overarching principles

- Clarity and transparency of objectives for the company and an approach which ensures clarity between the trade-offs in policy, regulation, customer and shareholder interests;
- A shared vision for the company based on agreed objectives which are explicitly agreed by the shareholder, the Board and the management team;
- Robust involvement by the shareholder around the exercise of its key levers of interest (ie. governance, appointments, strategy, incentivisation and performance monitoring); and
- An incentive framework that links rewards explicitly to profit and value performance over the long term.
- -No single shareholder model is applicable in its entirety to the Government's portfolio of companies. However, taking into account the nature of the Government's shareholdings and the relevance and limitations of the models described below (Annex A), many features of the private equity model are relevant to a Government Shareholder Model.

Annex A: comparison of primary shareholder models

	Shareholder roles	Monitoring activities	Limitations of model in Government context
Quoted company model	<ul style="list-style-type: none"> • Monitor adherence to good governance standards • Periodic voting • Buying and selling shares 	<ul style="list-style-type: none"> • Prelim/interim results • Occasional visits • AGMs/formal approvals • Very rare intervention 	<ul style="list-style-type: none"> • Diffuse shareholders; selling is the way of creating pressure • Focus on a single shareholder aim, i.e. financial • Share price; market scrutiny by analysts
Supervisory board model	<ul style="list-style-type: none"> • Supervisory board oversees rather than sets objectives • Recognise multiple stakeholder interests (eg employees, lending bodies, major shareholders) 	<ul style="list-style-type: none"> • Supervisory board meetings • Ad hoc direct negotiations with management 	<ul style="list-style-type: none"> • Board role to monitor, not to set objectives • Lack of transparency of management performance and over accountability issues
Private equity model	<ul style="list-style-type: none"> • Control Board appointments • Closely involved in agreeing strategy • Work proactively with Board/management to build shareholder value • Use financial incentives to align interests 	<ul style="list-style-type: none"> • Board meetings • Regular contact with management • Detailed financial reporting (in particular, sees management accounts/plans as well as audited results) 	<ul style="list-style-type: none"> • Single focus on financial value • Can be very hands on with company operations • Short term time horizon, i.e.. 3-5 years
Family owned group	<ul style="list-style-type: none"> • Typically focussed on long-term • Mediate differing interests (i.e. family, management, board) 	<ul style="list-style-type: none"> • Periodic meetings of family council • Direct involvement of family board members or managers 	<ul style="list-style-type: none"> • Opaque decision making and lack of accountability
Strategic minority shareholder model	<ul style="list-style-type: none"> • Play key role on board (either directly or through appointees) • Consent/veto rights over key decisions • Influencing strategy and key appointments 	<ul style="list-style-type: none"> • Board meetings • Direct influence with board members • May have special rights eg. information 	<ul style="list-style-type: none"> • Relies on special rights and/or influence • Board may be disenfranchised
Industrial conglomerate model	<ul style="list-style-type: none"> • Treats investments as a portfolio • Sets clear financial targets • Intervenes decisively in under performance 	<ul style="list-style-type: none"> • Company-specific performance management and financing cycles • Periodic strategy reviews • Frequent management interventions 	<ul style="list-style-type: none"> • More a management than a shareholder model

