# Corporate Governance Guidance and Principles for Unlisted Companies in the UK

Based on Guidance published by the Institute of Directors (IoD)

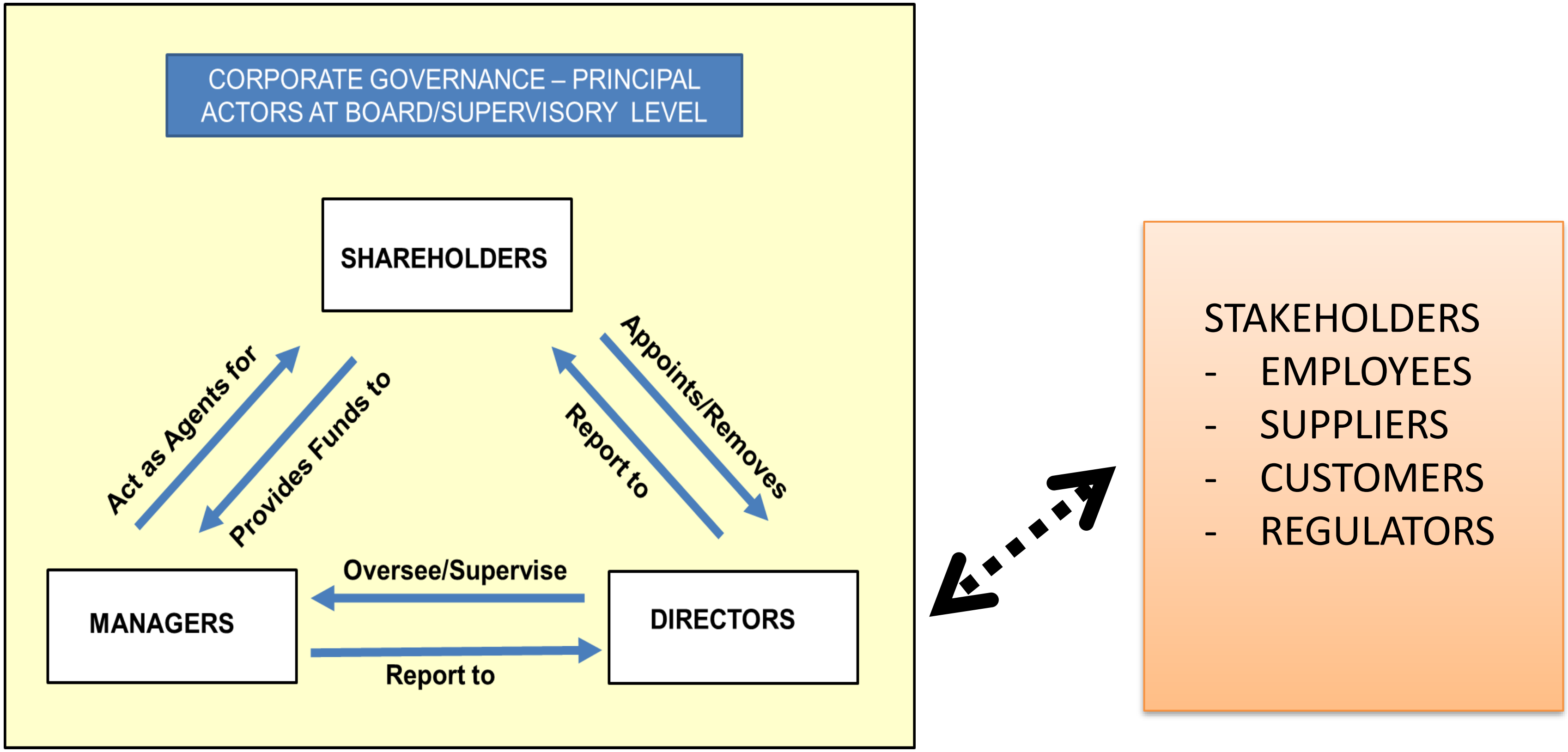
FAMILY GOVERNANCE ASSOCIATES

# TABLE OF CONTENTS

# Why corporate governance matters to unlisted companies

- Performance and internal efficiency
  - Important in shifting from dependence on unique contribution of its founding entrepreneur
  - Facilitates succession and allows access to wider pool of expertise and know-how
  - Governance an increasing issue as they seek external sources of finance (e.g. banks, investors)
  - Can result in improved leadership, decision-making and strategic vision coupled with better risk management
- Managing patient capital and illiquidity risk
  - Listed company owners can sell if in disagreement with management or concerned about riskiness of the business; unlisted company owners rely on effective corporate governance to ensure their interests are respected and safeguarded by the board and company management
  - Effective corporate governance makes shareholders more likely to invest in company in patient manner
- Building corporate reputation in line with societal expectations
  - A “license to operate” as it signals to external stakeholders the company is being run responsibly and with due regard to non-insiders’ interests
  - Robust governance can mitigate reputational risks

# Key actors in a governance framework




- UK Companies have fewer formal obligations to include stakeholders in their governance framework than some European countries but UK law requires the board to have regard to the interests of the company's employees, suppliers and customers in its decision-making and to think about the impact of the company's operations on the community and the environment

# Directors legal duties under UK law

- Duty to act within powers in accordance with the company's constitutive documents and only exercise powers for the purposes why were conferred
- Duty to promote the success of the company in good faith and with due regard to
  - Likely consequences of any decision in the long term
  - The interests of the company's employees
  - The need to foster the company's relationships with suppliers, customers and others
  - The impact of the company's operations on the community and the environment
  - Maintaining a reputation for high standards of business conduct
  - The need to act fairly as between members of the company
- Duty to exercise independent judgement
- Duty to exercise reasonable care, skill and due diligence
- Duty to avoid conflict of interest
- Duty not to accept benefits from third parties
- Duty to declare interest in proposed transaction or arrangement

# Foundations of good governance – key concepts (1)

1. Delegation of authority
   – Formalize which powers and responsibilities belong to which governance body (i.e. shareholders, board of directors and management)
2. Checks and balances
   – Subject actions of individuals to scrutiny with most important decision taken on collective basis
3. Professional decision-making
   – Atmosphere of open discussion to elicit independent views with dissenting voices recorded but striving for consensus between diverging views to allow clear decisions and decisive action to implement them
4. Accountability
   – Meaningful accountability of performance and exercise of powers with each superior level monitoring and supervising the level below it (i.e. employees accountable to management, management accountable to board, board accountable to shareholders and external stakeholders including government authorities and regulators)

# Foundations of good governance – key concepts (2)

5. Transparency

   - Sunlight is the best of all disinfectants and exceeding statutory standards by voluntarily disclosing more information than required by law is an effective means of gaining the confidence and commitment of external stakeholders

6. Conflicts of Interest

   - Good governance demands the company be steered by the board in an objective manner and not as a means of promoting specific personal interests or enriching a specific constituency by ensuring the existence of credible mechanisms by which potential conflicts of interest can be managed or resolved

7. Aligning incentives

   - Credible and transparent remuneration policy that takes into account relevant benchmarks and performance criteria can incentivize behavior from directors, managers and employees in a way that is consistent with the long term interests of the company and help win their commitment and loyalty

# The challenge of implementation

- Implementation of sound corporate governance can be challenging
  - Improved governance increases the formalization of company processes and procedures which can be perceived by employees/managers as imposing an unnecessary bureaucratic burden
  - Deferring to a board on major decisions, establishing chains of accountability and reporting to shareholders may be viewed with suspicion by the original owner-manager or founding entrepreneur

$\Rightarrow$ Implementation of best practices in corporate governance is likely to involve change in how a business is run and change is often difficult to accept

- Firm’s key decision-makers must themselves be convinced of the need to implement a robust governance framework and be committed to lead from the front
- Corporate governance is not an end in itself but a means of adding value and providing continuity and thus should be implemented in a proportionate and realistic manner

# Principles applicable to all unlisted companies

1. Shareholders should establish an appropriate constitutional and governance framework for the company
2. Every company should strive to establish an effective board which is collectively responsible for the long term success of the company, including the definition of the corporate strategy. However, an interim step on the road to an effective (and independent) board may be the creation of an advisory board
3. The size and composition of the Board should reflect the scale and complexity of the company's activities
4. The Board should meet sufficiently regularly to discharge its duties, and be supplied in a timely manner with appropriate information
5. Levels of remuneration should be sufficient to attract, retain and motivate executives and non-executives of the quality required to run the company successfully

# Principles applicable to all unlisted companies

6. The Board is responsible for risk oversight and should maintain a sound system of internal control to safeguard shareholders' investment and the company's assets
7. There should be a dialogue between the board and the shareholders based on mutual understanding of objectives. The board as a whole has responsibility for ensuring that a satisfactory dialogue with shareholders takes place. The board should not forget that all shareholders have to be treated equally.
8. All directors should receive induction on joining the board and should regularly update and refresh their skills and knowledge
9. Family controlled companies should establish family governance mechanisms that promote coordination and mutual understanding amongst family members as well as organize the relationships between family governance and corporate governance

# 1. Shareholders should establish an appropriate constitutional and governance framework

- Framework should delineate which matters are specifically reserved for shareholders' decisions and which are to be delegated to the board
- Articles of the company represent a contract between the company and its owners
- The board is the primary decision-making body of the company and should not be undermined by over-prescriptive articles
- The constitutional framework safeguards shareholders' interests and defines relationships and conflict-resolution procedures between shareholders
- Shareholders Agreements as contractual agreements may be seen as a more flexible and effective means of safeguarding shareholder rights than the company's article, but as a private contract they are less transparent

# 2. Companies need an effective board of directors but advisory board may be transitional step

- The Board provides leadership and is collectively responsible for the long term success of the business
  - Formulates long term strategy
  - Hires/Fires senior management team and CEO
  - Allocates capital and other resources
  - Monitors and rewards performance/sanctions underperformance
  - Ensures compliance with laws and regulations
  - Sets the company's values and standards and ensures company meets its obligations to its shareholders and other stakeholders
- An advisory board can be a transitional step to a more independent board as company evolves
- Large, complex companies with owners less active in management, benefit from strongly independent boards of directors
- Boards should utilize written statements to ensure clarity of objectives, strategy and policies and should strive for effective dialogue with management and shareholders

# 2. Effective governance requires shareholders, board and management to be clear on their role and responsibilities

- Schedule of matters reserved for shareholders
  - Approval of annual accounts and deciding on dividends
  - Approval of changes to articles/capital structure
  - Appointment, remuneration, dismissal of board
- Schedule of matters reserved for the board
  - Definition of corporate goals, strategy, structure
  - Responding to shareholders and third parties
  - Supervising and controlling company's progress and management
  - Approval of major corporate actions (e.g. acquisitions, disposals, entry into new markets, exit from businesses)
  - Approval of borrowings and investments
  - Approval of financial statements
  - Definition of what is delegated to management
  - Hiring, compensation and dismissal of CEO and of other senior officers (in consultation with CEO)
  - Policies on external comunications (e.g. regulators, shareholders, media)
- Schedule of matters delegated to management
  - Preparation of strategic proposals, business plans and budgets
  - Executing strategy approved by the board
  - Signing contracts and regulatory documents
  - External communications
  - Establishing system of internal controls and risk management
  - Health and Safety operations

# 3. Size and composition of Board in line with scale and complexity of the business

- Boards should not be so large as to slow decision-making
- Board should collectively have a balance of skills and experience appropriate for the requirements of the business
  - Executive and non-executive directors bring different perspectives
  - Independent directors, including possibly an independent chairman, provide a balancing influence on company boards
- Board itself should ensure plans in place for orderly succession for the board and senior management
- Board members' term limits carefully considered to ensure planned and progressive refreshing
- Board members need to enjoy legitimacy and confidence of shareholders

# 4. Board should meet on regular basis and get timely and appropriate information

- Calendar of board meetings should be agreed in advance and respected as much as possible
  - Specific topics should be included in specific board meetings to ensure adequately periodic review and discussion and possibly action/decisions
- Meetings' frequency should provide sufficient opportunity for board to act in its supervisory and strategy setting role without becoming operational
  - Start-ups and turnarounds will require greater frequency than well performing businesses
- Board chairman should set and circulate agenda ahead of meeting together with minutes from previous meeting
- Board members should be provided with sufficient information by management ahead of meetings and management should be available at meetings for further discussion/elaboration
- Directors should be able to supplement the information received from management from other channels, including company/department visits, external reports and regulators

# 4. Art and science of board materials affects boards' effectiveness

- Boards need to guide management on what information is needed and what format is to be provided
- Boards have overall responsibility for the company and that requires holistic viewpoint

⇒ Balanced scorecard used by many boards to ensure holistic information

  - Financial and other quantitative information
  - Measures of customer satisfaction
  - Indicators of training and professional development amongst employees
  - Compliance with health & safety standards and other regulatory requirements
  - Progress on major projects and management initiatives

# 5. Remuneration set to attract, retain and motivate executives and non-executives

- Remuneration should reflect differing roles of executives and non-executives
- No one should be involved in deciding his/her own remuneration
- Boards should ensure remuneration of CEO and senior managers reflects their skills, experience and responsibilities in context of competitive market place
- Executive compensation design should consider :
  - Balance between fixed and variable pay, and variable pay linked to pre-determined performance criteria
  - Deferment and claw back right of some part of variable pay
  - Limits on severance pay and non-payment of severance in case of poor performance

# 6. Board is responsible for risk oversight

- Boards need to identify the main risks facing the company and consider how they are being managed
  - Periodically assess need to establish formal internal control and risk management function
  - SWOT, PESTEL and other analytical tools can assist in risk mapping
- Boards can find it useful to develop a risk register
  - Describe risks, impact if they occur, probabilities of occurrence
  - Risk mitigation measures (i.e. reduce probability or impact of an event)
  - Responses if an event should occur
- Boards in larger companies may form audit committees and/or introduce an internal audit function
- Boards must lead in setting policies and procedures in risk areas
  - Anti-fraud, anti money-laundering
  - Records management, Data security and reliability
  - Cash management , security over premises and asset protection
  - Regulatory, fiscal, health & safety compliance
  - Accounting reconciliations and monitoring of cashflow
  - Suitable qualifications and training, authorization limits, segregation of duties

# 7. Dialogue between Board and Shareholders and all shareholders treated equally

- Chairman has particular responsibility to ensure effective communication between shareholders and board
- Relationship between board and shareholders is a continuous process and not limited to an annual formal meeting
- Boards need to find mechanisms to ensure dissemination of information in fair and equal way for all shareholders
- Particular areas Boards need to consider in communications to shareholders include
  - Company's strategy
  - Risk profile
- Boards need to communicate with shareholders in understandable and meaningful way and in spirit that recognizes key duty of board is to ensure activities of the company remain aligned with the interests of the shareholders
- Boards – shareholders dialogue needs to reflect the particular circumstances of the company

# 8. Directors should receive induction and regularly update and refresh their skills and knowledge

- New director(s) should have induction whose rigour should reflect the size and complexity of the enterprise
  - Director orientation should be used to provide non-executive directors with the informational building blocks they need to effectively engage in strategic reflection and oversight
- The Chairman should ensure directors continually update their skills and obtain knowledge and familiarity with the company required to fulfil their role on the board
- The Chairman should encourage board members to engage in professional training that enhances their functioning as directors

# 9. Family controlled companies should establish family governance

- The design of family governance depends on a number of factors
  - Stage of family ownership (i.e. owner/founder, siblings partnership, cousin federation)
  - Size of the business and degree of family members' involvement in the business
- A family constitution is a useful tool to
  - Outline the vision and objectives of the family for the business
  - Define roles of family governing bodies and their relationship with the company's board of directors
  - State key family policies (e.g. family members' employment, transfer of shares, education and training)
- Family governance bodies, family assembly and family council provide family members with a forum to discuss the affairs of the family and the family business and assist in the development of a coordinated family approach
  - Family Assembly meeting 1-2 times in a year and allows family members to stay informed about the business, voice their views and helps avoid conflict from unequal access to information
  - Family council, usually elected by the Family Assembly, acts as primary decision making body and communication link of the family vis a vis the company
- Family governance institutions should be distinctly separate from the formal governance structure of the company but their interaction will mutually enhance both family governance and corporate governance

# Principles applicable to larger/more complex unlisted companies and/or aspiring to IPO

10. There should be a clear division of responsibilities at the head of the company between the running of the board and the running of the company's business. No one individual should have unfettered powers of decision
11. All Boards should contain directors with sufficient mix of competencies and experiences. No single person (or small group of individuals) should dominate the board's decision-making
12. The Board should establish appropriate board committees in order to allow a more effective discharge of its duties
13. The Board should undertake a periodic appraisal of its performance and that of each individual director
14. The Board should present a balanced and understandable assessment of the company's position and prospects for external stakeholders and establish a suitable program of stakeholder engagement

# 10. Clear division of responsibilities of Board chairman and CEO

- No individual should have unfettered powers of decision
  - Split the roles of CEO and Board Chairman
- Division of responsibilities between Board chairman and CEO should be clearly established, set out in writing and agreed by the Board
  - Division of responsibilities needs to be reviewed periodically
- Chairman’s responsibilities include coordinating the contributions of the non-executive directors to ensure the executive team is subject to sufficient degree of oversight
- Board chairman’s role is finely balanced as he/she must be sufficiently informed, engaged and able to intervene when required but must avoid becoming too involved with the day-to-day business of the company

# 11. All Boards should contain directors with sufficient mix of competencies and experiences.

- Boards should include both executive and non-executive directors and for larger unlisted or companies aspiring to listing Boards should include independent directors as well
- Chairmen and non-executive directors need to have enough time to devote to the job.
- Non-executive and independent directors should be able to
  - Constructively challenge and help develop strategy proposals
  - Scrutinize overall performance relative to goals and objectives and the reporting of performance
  - Satisfy themselves on the integrity of financial information and ensure financial controls and risk management systems are robust
  - Assume primary responsibility on remuneration and succession planning matters
- Chairman may hold meetings with non-executive directors without the executive directors present
- Non-executive directors should be subject to term limits to ensure Board renewal

⇒ No single person or small group of individuals should dominate the board's decision-making

# 11. Key benefits from Independent Directors

- Bringing an outside perspective on strategy and control
- Adding new skills and knowledge that may not be available within the firm
- Bringing an independent and objective view from that of the owner
- Making hiring and promotion decisions independent of family ties
- Bringing an independent view whenever there may be conflicts of interest within the board
- Acting as a balancing element between the different shareholders (e.g. members of the family) and in some cases serving as objective mediator/arbiter of disagreements amongst family members or managers
- Benefiting from their business connections and other contacts

# 12. Board should utilize committees to enhance its effectiveness

- A Board’s committee structure should reflect the needs of the company
  - Remuneration, Nominations, Audit committees
- Board should define in writing the terms of reference for each committee
  - Explain the role and the advisory authority delegated to them by the Board
- Committees need to be provided with adequate resources to carry out their duties
- Independent non-executive directors should play a significant role in board committees

# 12. Board committees need clear terms of reference

- Nominations Committee
  - Lead process for board appointments
  - Lead process of CEO recruitment
  - Lead and coordinate management succession plan
- Remuneration Committee
  - Propose remuneration for all executives
- Audit Committee
  - Monitor integrity of company's financial statements
  - Review company's internal controls and risk management systems
  - Lead appointment of external auditor and approve their remuneration and terms of engagement
  - Review and monitor external auditor's independence and effectiveness
  - Review company's risk profile and monitor risk management processes

# 13. Board should be subject to periodic appraisal as a group and individually

- The rigour and formality of appraisal of the Board as a group and individually should reflect the size and complexity of the business
- Chairman should use the appraisal process to get feedback on his/her effectiveness in managing the board
- Group appraisal should examine the board's record as a collective decision-making body and the collaboration with the executive management team
- Individual director appraisals should aim assess whether each director continues to contribute effectively and remains committed to the role
- Chairman should act on the results of the appraisal process by recognizing the strengths and addressing the weaknesses, including where appropriate proposing new members or seeking resignation of underperforming incumbent directors

# 13. Key issues in Board appraisals

- Is the distribution of power in boardroom appropriate ?
- Is there sufficient challenge of executive management in board meetings ?
- Does the board have the right balance between expertise and independence ?
- Does the board perform its duties correctly ? Are directors setting direction and monitoring the company and its management ?
- Do board members devote sufficient time and effort to the company and their role ?
- Do the board members have adequate access to information and advice ?
- Does the board engage sufficiently with shareholders and key stakeholders?
- Are there personal factors that might inhibit individual board members from fulfilling their duties in an independent and objective manner ?

# 14. Board should present the company's position and prospects to shareholders fairly

- Apart from financial reporting, Boards should strive to report on at least an annual basis
  - Narrative of the company's strategy and the risks associated with it
  - Statement of the company's vision and values
  - Review of the company's activities and performance coupled with description of its market environment and a forward looking assessment of the its business environment
  - Statement of its corporate governance principles and the extend of compliance with a specific governance code
  - Summary of activities and projects relevant to stakeholders
- Strong disclosure that promotes transparency becomes a key element of a company's relationship with shareholders and stakeholders

# 14. Board should engage with stakeholders

- Disclosure and stakeholder engagement improves
  - Public understanding of the structure and activities of the company
  - Public understanding of its policies in respect of environmental and ethical standards
  - Its relationship with the communities in which it operates
- Direct communications between Board and employees within an internal governance policy can be effective in getting everyone to “sing from same music” provided it is done carefully to avoid the authority of the executive management and CEO being undermined
- Stakeholders, including individual employees or their representative bodies, should be able to freely communicate to the board any concerns about illegal or unethical practices and the Board establish procedures for safe harbours for complaints by stakeholders