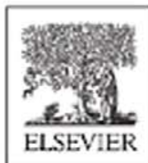

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Corporate Governance

A practical guide for accountants

Catherine Turner

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A Practical Guide for Accountants

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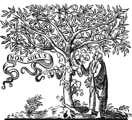

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Contents

Introduction vii

Section 1 Background Issues 1

1 What is Corporate Governance? 3

2 Overview of Corporate Governance Codes, Rules, Guidance and Other Publications 23

3 Governance Post-Companies Act 2006, with Specific Reference to Shareholder Issues 47

Section 2 A Practical Guide to Establishing a Framework 69

4 Corporate Governance Post-Companies Act 2006, Part 2 71

5 Internal Controls and Risk Management 103

6 Disclosure and Reporting Responsibilities 123

7 Directors' Remuneration 163

Index 183

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Introduction

The term 'Corporate Governance' was at one time a term used to indicate a slightly touchy-feely set of considerations which were often regarded as optional: being indicative of such loose ideas as 'best practice', and other phrases open to multiple interpretations.

Since those days, the term has evolved to become much more embedded in corporate consciousness; it implies an adherence to generally accepted good standards of practice and control. In an environment where accountability is of increasing importance, and where duties of care are now in many cases codified into statute, corporate governance is an essential part of the everyday controls a company's board and management – and indeed its shareholders – should consider on a regular basis. This book aims to track some of the key issues in corporate governance, their evolution, future possible direction, and current interpretation. It focuses in particular on changes brought about in UK company law by way of the Companies Act 2006, but also discusses international initiatives where these are influential. Practical examples of the considerations which might be brought to bear are also included.

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Section 1

Background Issues

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What is Corporate Governance?

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1.1 Definition

The term 'Corporate Governance' has no single formal definition, and is often therefore used in a variety of differing ways (along with that other serial victim of flabby usage – 'Best Practice'). Generally speaking, however, the term is used to describe a range of issues relating to the ways in which companies may be directed and controlled. It is, broadly, the systems and processes for ensuring proper accountability, probity and openness in the conduct of an organization's business.

In some circles the term is also used to encompass wider issues relating to:

- the improvement of shareholders' performance; and
- other stakeholder arguments focused on addressing precisely whose interests a company, and its operators, ought properly to take into account.

Stakeholders, of course, can include not only shareholders, but also customers, employees, retired employees (pensioners), suppliers, lenders and the wider community within which the company operates.

1.2 Some key concepts encountered in the world of corporate governance

1.2.1 Codes of governance

In general, good corporate governance involves management judgement and is essentially voluntary in nature. However, there are a number of areas, as we shall see, where compliance is mandatory – either as a condition of continued membership of a particular body, or as a result of specific legislation. In Chapter 2, we will look at some relevant codes, consider their origins, their status (mandatory or voluntary), and look at how some have been adapted for specific types of organization.

1.2.2 Enlightened shareholder value

This refers to a concept introduced under the Companies Act 2006. Section 172 of this act introduced the idea of

'enlightened shareholder value' into the duty to promote the success of the company for the members' benefit. It requires that a director act in the way which he believes, in good faith, to be most likely to promote the success of the company for the benefit of its members as a whole. In fulfilling this duty, he must have regard – *inter alia* – to:

- The likely long-term consequences of any decision;
- The interests of the company's employees;
- The need to foster the company's business relationships with suppliers, customers and other parties;
- The impact of the company's operations on the community and the environment;
- The desirability of the company's maintaining a reputation for high standards of business conduct; and
- The need to act fairly as between the members of the company.

We will look further at this concept in later chapters.

1.2.3 Annual business review

A company's Annual Business Review (ABR) forms part of its annual report, and as a concept has been re-stated and expanded under the Companies Act 2006 – particularly for quoted companies. The ABR is intended to provide shareholders with a balanced and comprehensive analysis of the development and performance of the company and its position, together with a fair review of the business and a description of the principal risks and uncertainties faced.

There are additional requirements (recently amended, during the House of Commons debates) for quoted companies. One of the stated purposes of this review is to enable the shareholders to assess how the directors have performed their duty to promote the success of the company. We will consider this duty, and its impact on the ABR, in Chapter 4.

1.2.4 Corporate social responsibility

Corporate Social Responsibility (CSR) is another term which, like corporate governance, can mean many things to many

people. In many ways it is not a new concept – its roots may be found in the activities of those socially enlightened Victorian industrialists who provided their factory employees with a range of non-pay benefits such as:

- acceptable housing;
- educational opportunities; and
- in some cases, the chance to enjoy other aspects of culture and self-improvement.

A simple definition might be 'the idea of social responsibility (in a range of forms), as exercised by corporate enterprises'.

A fuller description can be found at the website of the UK Government:

- www.csr.gov.uk/whatiscsr.shtml

This states: 'The Government sees CSR as the business contribution to our sustainable development goals. Essentially it is about how business takes account of its economic, social and environmental impacts in the way it operates – maximising the benefits and minimising the downsides. Specifically, we see CSR as the voluntary actions that business can take, over and above compliance with minimum legal requirements, to address both its own competitive interests and the interests of wider society… CSR is essentially about companies moving beyond a base of legal compliance to integrating socially responsible behaviour into their core values, in recognition of the sound business benefits in doing so.'

CSR is an increasing consideration within the wider world of corporate governance, as it continues to move from being an essentially voluntary, aspirational set of principles to being embedded in certain non-voluntary codes and statutes. For this reason you will come across frequent references to the concept in this book.

Why would a company choose to embrace CSR principles, with all the additional effort and cost this involves, especially in the straightened times in which we find ourselves? There are a number of key drivers:

- **External demand**: The past decade has seen increasing calls for CSR adoption on the part of shareholders,

government, various public interest groupings and other stakeholders – as a result of which many business have chosen to respond proactively.

- **Internal/commercial drivers**: Various studies have indicated that businesses incorporating CSR into their governance frameworks can better:
  - Manage certain of their risks;
  - Improve their competitive standing, by gaining and retaining customers and enhancing the business's value;
  - Avoid various types of controversy or reputational risk;
  - Consequently, over the long haul, enhance their brand's reputation;
  - Encourage employee recruitment, retention and performance; and
  - Foster a corporate culture and value set which can help to distinguish and promote their brands' evolution.

1.2.5 Some potential components of CSR

CSR can, as we have noted, mean different things to different people. The following grid sets out just some of the potential components which companies are known to include, in practice, in their CSR agenda-setting.

Ethics	Environment	Diversity
Altruism	Wider society	Human rights
Integrity	The future	Labour chain
Climate change	Philanthropy	Accountability
Sustainability	Values	Community
Human capital	Morality	Stakeholders
Transparency	Fair trade	The long term

1.3 Corporate governance rules

Generally speaking, as we have seen, most corporate governance principles are embedded in voluntary or semi-voluntary codes. However, in the context of the Financial Services and Markets Act 2000, provisions for certain 'corporate governance rules' are made at Section 890(1). These relate to the task of implementing, facilitating the implementation of, or otherwise

handling issues arising from any European Community obligations relating to the corporate governance of issuers of securities, where those issuers have requested or approved admission to trading of their securities. These rules can be found in Chapters 1B, 4 and 7 of the Disclosure and Transparency Rules – part of the FSA's Handbook of Rules.

1.4 The emerging UK and international trends

1.4.1 The history

During the 1990s, corporate governance was very much in the spotlight following the publication of a number of important reports, all of which have had an influence on the corporate governance environment in which we operate today:

- **The Cadbury report (1992)**: This report produced a Code of Best Practice for listed companies which was the forerunner to the Combined Code of today;
- **The Greenbury report (1995)**: Greenbury developed recommendations on the setting and disclosure of directors' remuneration in the form of the Greenbury Code of Best Practice;
- **The Hampel report (1998)**: This report resulted in the Combined Code (1998) (which replaced the Cadbury and Greenbury Codes of Best Practice) and led to the Turnbull guidance on internal control (1999); and
- In 2003, the publication of the **Higgs report** provoked a great deal of discussion on corporate governance and led to a significant rewriting of the Combined Code, culminating in 2003 version of the Code. A further revised version of the Combined Code was published in June 2006. The June 2006 version of the Code is effective for reporting periods beginning on or after 1 November 2006.

The current UK corporate governance environment does not exist in isolation: it must be viewed in the context of influences from Europe and the US. In 2002, the collapse of Enron and WorldCom meant that issues of corporate governance would continue to remain highly topical and lead to further scrutiny of corporate governance in the UK.

1.4.2 'Global corporate governance'

There is, as yet, no generally applicable global corporate governance model. Corporations work within the parameters set by national laws and regulations, and the economic goals and expectations of shareholders and other stakeholders.

The basic principles found in good corporate governance systems include transparency, accountability, fairness and responsibility, put into practice by a combination of statutory rules and self-regulation in the form of Codes of Best Practice. The foundation of corporate governance is disclosure: this encourages the confidence and trust required by all stakeholders.

There has been some measure of convergence in corporate governance practice internationally, resulting from the standards being required by international investors and capital markets. There are also initiatives by the World Bank and the Organisation for Economic Co-operation and Development (OECD) to provide a theoretical and analytic framework (see the OECD's website and the website of the Global Governance Forum).

In particular, in April 2004, the OECD published a revised version of its Principles of Corporate Governance, and in April 2005, it announced the launch of a Business Sector Group to give practical guidance to board members trying to improve corporate governance. It is proposed that the Group will produce a boardroom guide to the OECD Principles of Corporate Governance, including concrete examples and advice on how board members can put good corporate governance into practice, notably in the absence of detailed or prescriptive regulation.

On 1 December 2006, the OECD took a further step towards facilitating the use of the OECD Principles of Corporate Governance by releasing a Methodology for Assessing Implementation of the OECD Principles. The Methodology can be used by independent assessors and for self-assessments by, national authorities. It will also be used by the World Bank under its Review of Standards and Codes programme.

In September 2008, the OECD announced the launch of a drive to raise the standards of corporate governance as good corporate governance has been recognized during the current financial markets turmoil as 'one of the keys to healthy financial markets'. Part of this work will involve 'strengthening' the implementation of the OECD's Principles of Corporate Governance. The OECD plans to meet with representatives of governments, regulators, industry and other interested parties to discuss the lessons for corporate governance that need to be learnt from the financial crisis. Following these discussions, the OECD intends to publish a statement of its findings and recommendations after the meeting of its corporate governance steering group on 19 and 20 November 2008.

In September 2005, the OECD published guidelines on corporate governance on state-owned enterprises. These guidelines provide the first international benchmark to help governments assess the way they exercise their ownership responsibilities vis-à-vis state-owned enterprises. They are non-binding and complementary to the OECD Principles of Corporate Governance.

The United Nations is also helping to develop more of a global corporate governance environment through the publication, in April 2006, of its 'Principles for Responsible Investment', a set of voluntary guidelines aimed to encourage investors to address environmental, social and governance concerns.

1.4.3 The influence of Europe

Recent European developments are key influences on the UK corporate governance environment and its future evolution.

The European Action Plan on Company Law and Corporate Governance: On 21 May 2003 the European Commission released for consultation an Action Plan on company law and corporate governance ('Modernising Company Law and Enhancing Corporate Governance in the EU'). The main objectives of the Action Plan are to:

- Strengthen shareholders' rights and protection for employees, creditors and the other parties with which

companies deal, while adapting company law and corporate governance rules appropriately for different categories of company; and

- Foster the efficiency and competitiveness of business, with special attention to some specific cross-border issues.

The Action Plan sets out priorities for the short term (2003–2005), medium term (2006–2008) and long term (2009 onwards), and indicates which type of regulatory instrument should be used for each proposal, with approximate timescales. The Action Plan contains 24 measures. Some of the measures have already been adopted; some are currently being negotiated; and most measures are meant to be adopted before 2009.

The Commission does not, apparently, intend to introduce a European Corporate Governance Code; however, it considers that the European Union should adopt a common approach covering a few essential rules and ensure adequate coordination of national corporate governance codes.

To date, the Commission has taken the following corporate governance measures under the Action Plan:

- **Annual corporate governance statement**: Directive 2006/46/EC. This Directive was published in the Official Journal on 16 August 2006 (Directive 2006/46/EC of the European Parliament and of the Council of 14 June 2006). Member states must implement it by 5 September 2008. The directive amends the Fourth Company Law Directive (78/660/EEC) and the Seventh Company Law Directive (83/349/EEC) (Accounting Directives) to give effect to the proposal that all listed EU companies should provide a corporate governance statement in their annual report or by way of reference in their annual report to a document publicly available on the company's website. This expands on the disclosure requirements about control structures under the Takeover Directive (2004/25/EC), by requiring that the corporate governance statement also includes:
  - a 'comply or explain requirement' with reference to the national corporate governance code;

- all relevant information about the corporate governance practices the company applies over and above the requirements under national law;
- a description of the company's internal control and risk management systems in respect of such systems which relate to the company's financial reporting process;
- information about the operation of the shareholders' meeting; and
- details of the composition and operation of the board and its committees.

In addition, in relation to groups, the consolidated annual report should include a description of the group's internal control and risk management systems in relation to the process for preparing consolidated reports. The Directive also includes a provision that board members of limited companies are collectively responsible to the company for ensuring that both the annual and consolidated accounts and reports are drawn up in accordance with the Directive. Member states must have appropriate sanctions and liability rules where board members do not comply with accounting rules. Member states may allow listed companies, which have only issued securities other than shares to trading on regulated markets, to limit the information they must include in their corporate government statement.

In the UK, from 29 June 2008, a new chapter of the Financial Services Authority's Disclosure and Transparency Rules (DTR 7) provides companies with a choice of whether to publish the statement in the directors' report or in a statement separate to the directors' report and provide the ability to cross-reference to avoid duplication of information.

- **Strengthening shareholder's rights.** Following consultation by the Commission, on 11 July 2007, the Directive on the exercise of certain rights of shareholders in listed companies was published in the *Official Journal* (2007/36/EC). Member states must implement the Directive by 3 August 2009. The Directive establishes requirements for the exercise of certain shareholder rights that are attached to voting shares of companies with a registered office in a member state and shares admitted to trading on a regulated market. Among other things, the Directive provides for:

- Companies to give 21 days' notice of a general meeting (other than for the annual general meeting, this can be reduced to 14 days with shareholder consent and provided the company offers the facility for all shareholders to vote by electronic means) and to publish the notice on the company's website at least 21 days before the general meeting;
- The right to participate in a general meeting not being subject to a requirement to block shares by deposit and the introduction of a record date which cannot be more than 30 days before the general meeting;
- The abolition of obstacles on electronic participation to the general meeting;
- The right to put items on the agenda of the general meeting;
- The abolition of any rules restricting eligibility of people to act as proxy holder; and
- The disclosure of the voting results on the company's website.

The Commission is considering the need to adopt a separate non-binding instrument on shareholders' rights to supplement the Directive. In May 2007, the Commission published a consultation paper to assess the need and appropriateness of such an instrument. On 27 September 2007, the Commission published a report on the consultation.

On 26 October 2006, the DTI (now BERR) published a consultation paper seeking views on the Directive. The government published its response in May 2007.

On 24 October 2008, BERR published Implementation of the Directive on the Exercise of Certain Rights of Shareholders in Listed Companies – A consultation document. The consultation sets out BERR's proposed approach to the implementation of the Directive. Draft regulations implementing the Directive are attached to the consultation. In addition to implementing the Directive, BERR has also taken the opportunity to correct some anomalies in the existing law on shareholders' rights contained in the Companies Act 2006. The consultation period closed on 30 January 2009, and BERR has said that it will publish a summary of responses within three months of the consultation closing. Subject to the outcome of this consultation, BERR will implement the Directive.

- **Board composition.** Following its consultation on the role in listed companies of non-executive or supervisory directors, the final text of a Recommendation aimed at promoting the role of (independent) non-executive or supervisory directors, was published in the *Official Journal*. Unlike the Code in the UK, the Action Plan advocates that the responsibility for identifying candidates to fill board vacancies should be given to a group composed mainly of executive directors since, in the Commission's view, they can usually use their skills in this area. Non-executive directors should, nonetheless, also be included and specific safeguards should be put in place to deal with conflicts of interest when they arise. On 19 July 2007, the Commission published a report on member states' application of the Recommendation. The report notes that there has been a clear trend towards improving corporate governance standards in the EU, that most member states have complied with the Recommendation almost fully or to a large extent, but that there has been some non-compliance (where some member states have failed to recommend a sufficient number of independent board members in remuneration and audit committees and some member states have failed to set a cooling-off period before a former CEO of a company can still become its chairman). The Commission will undertake further evaluation before determining whether it should take further action on this issue.
- **Directors' remuneration**. In October 2004 the Commission adopted a Recommendation on fostering an appropriate regime across the EU for the remuneration of directors to put in place an appropriate regulatory regime giving shareholders more transparency and influence, including detailed disclosure of individual remuneration. The Recommendation is similar to those already in force in the UK by virtue of the Directors' Remuneration Report Regulations 2002. It gives member states the option to provide that, without prejudice to national law, a shareholder vote on the remuneration policy (or every significant change to the policy) will only be organized if requested by at least 25% of the votes held by shareholders represented at the

meeting; only 'material or significant' additional remuneration paid to a director for special services must be disclosed; and the number of shares granted to a director as well as options offered must be disclosed. Member states were invited, but not required, to implement the necessary measures by 30 June 2006. On 19 July 2007, the Commission published a report on member states' application of the Recommendation. The report notes that a large majority of member states have introduced high disclosure standards on the remuneration of individual executives, but the Commission is disappointed with the application of the recommendations on disclosure of remuneration policy and putting the remuneration criteria of the board to shareholder vote. In the report, the Commission states that it expected more progress on those recommendations which aim at eliminating conflicts of interest, but it noted that most member states recommend or require shareholder approval of share incentive schemes. The Commission will monitor market developments before determining whether it should take further action on this issue.

- **European Corporate Governance Forum and expert advisory group**. This forum was set up by the Commission in October 2004. It is a committee of 15 members including two UK representatives meeting every four to six months. Its objectives are to examine best practice in EU member states with a view to facilitate convergence of national corporate governance codes, and to provide strategic advice to the Commission. For example, in February 2006, the forum published a statement on the comply or explain principle. In addition to this forum, in April 2005, the Commission set up an expert advisory group to provide detailed technical advice on preparing corporate governance and company law measures. The group comprises 20 non-governmental experts from various professional backgrounds. Members of the group have been appointed for three years. The group will be consulted by the Commission on a regular basis. The group's advice will supplement, not replace, public consultations on Commission's initiatives. The Commission will regularly consult the group, chair the group meetings and establish the calendar for meetings.

Corporate governance measures which have yet to be actioned include:

- **Disclosure by institutional investors**. A proposed directive for disclosure by institutional investors of their investment and voting policies is due to be published by the Commission in the medium term;
- **Board structure**. A proposal for a directive to allow all listed companies to choose between monistic and dualistic (one or two tier) board structures is planned to be published in the medium term.
- **Responsibilities of board members**. A proposal for a directive to enhance responsibilities of board members introducing a special investigation right, a wrongful trading rule and directors' disqualification is planned to be published in the medium term.
- **Full shareholder democracy.** A study to examine the consequences of an approach aimed at achieving a full shareholder democracy for listed companies (one share/one vote) was carried out in 2007. In a speech to the European Parliamentary Legal Affairs Committee given by Commissioner Charlie McCreevy, on 3 October 2007, it was indicated that the study found no economic evidence of a causal link between deviations from the proportionality principle and how companies perform. The final conclusion is that there will be no further action in this area and that there is already sufficient EU legislation on transparency.

In addition to the above measures on corporate governance, the Action Plan also covers the following measures:

- **Capital maintenance**. This includes:
  - A Directive as regards the formation of public limited liability companies and the maintenance and alteration of their capital (2006/68/EC). This Directive amends the Second Company Law Directive (77/91/EEC) to make it easier for public companies to take certain measures affecting the size, structure and ownership of their capital;
  - A study by the Commission into the feasibility of an alternative to the current regime of minimum capital as established by the Second Company Law Directive.

- **Groups of companies and pyramids.** This includes:
  - A proposal for a directive providing a framework rule for groups that would allow the adoption at subsidiary level of a coordinated group policy. This proposal is yet to come to fruition and is due to be published in the medium term;
  - A proposal for a directive to prohibit abusive pyramids (i.e., chains of holding companies with ultimate control based on a small total investment due to the extensive use of minority shareholders) being listed on the stock exchange. This is expected to be published in the medium term'
- **Corporate restructuring and mobility**. This includes:
  - The Cross-Border Mergers Directive (2005/56/EC) which requires member states to put in place a legal framework enabling public and private companies within the EU to engage in mergers across borders. Member states had to implement the Directive by 15 December 2007;
  - Directive 2007/63/EC amending the Third and Sixth Company Law Directives (78/855/EEC and 82/891/EEC) concerning mergers and divisions of public limited companies relating to the requirement for an independent expert's report on merger or a division of a public limited company.

Although once mooted, the Commission will not be proceeding with a formal proposal for a directive on cross-border transfer of registered office (as originally proposed in 2004) as legal means already exist to allow cross-border transfers.

- **European legal forms of enterprises**. The Commission is proposing a European Private Company which is to parallel the Societas Europaea (European public company) to serve the needs of SMEs which are active in more than one member state. On 25 June 2008 the Commission formally adopted the proposal for a Council Regulation on the European Private Company Statute and on 16 October 2008, in the UK, BERR published a consultation document seeking comments on the proposal. There are also proposals for a European Association and a European

Mutual Society but no formal action has been taken on this matter yet. There is also likely to be a study to assess the need for the creation of other EU legal forms for enterprises such as a European Foundation.

- **Transparency of national legal forms**. A proposal to preserve fair competition and prevent company law from being abused for criminal activity is yet to be proposed in the medium term.

The full measure of the practical impact of the Action Plan will depend on the degree of regulation imposed at EU level and the extent to which member states are to be given discretion to legislate and set appropriate guidance at a national level.

For countries such as the UK, which have developed an approach to corporate governance based on best practice, the use of codes and a comply or explain approach, the prospect of prescriptive legislation and rigid enforcement is not necessarily a welcome one.

On 20 July 2005, the then Department of Trade and Industry (now BERR) published a guide ('Promoting Competitiveness: The UK Approach To EU Company Law And Corporate Governance') designed to get business more directly involved in shaping EU policy in corporate law and governance.

1.4.4 US developments

The Enron and WorldCom scandals, the so-called 'pinstripe-plunder' in the US, prompted new legislation in the form of the Sarbanes–Oxley Act and changes to the rules of the National Association of Securities Dealers and New York Stock Exchange.

These changes include CEO and CFO certification of financial statements, certification of annual and quarterly reports filed with the SEC (including sign off on not misleading/ internal controls), the requirement for a wholly independent audit committee and hefty penalties for those involved in wrong-doing (including the reimbursement of benefits),

rapid and current disclosure requirement, increased regulation of accountancy firms, and rules to address conflicts of interest in connection with analysts' recommendation of equities.

1.4.5 Increasing focus on CSR

CSR is not new. Many companies have, for many decades, conducted their businesses with an eye to more than mere profit – that is, being mindful also of their impact on wider society. However, recent years have seen a growing impetus evolve – from government, investors and some businesses – to bring into the mainstream CSR considerations, so that it is no longer seen as a rather touchy-feely 'nice to have', but sits increasingly at the centre of a company's strategy.

Evidence of this impetus can be seen in the following:

- A general increase in calls for CSR from investor representative groups (we will look further at the idea of shareholder responsibility in Chapter 4, 'Directors and Shareholders');
- Building on the above, shareholder pressure in respect of specific issues – for example, the shareholder resolution initiated by TV's Hugh Fearnley-Whittingstall at a Tesco Annual General Meeting, which was supported by the Pensions Investment Research Consultants and which called for a commitment on the part of the company to the 'five freedoms' concept (this concept relates to principles for the welfare of farm animals);
- Statutory change, for example the evolving shareholder value approach enshrined in the directors' duties provisions of the Companies Act 2006;
- In some cases, an altruistic desire on the part of the directors and management of a company to adopt (and be seen to adopt) a more socially responsible position.

It seems likely that CSR will continue to move up the agenda, notwithstanding (and to a degree perhaps because of) the economic pressures of the times. Clearly, many companies have already seriously committed to CSR in devising

a strategy, pursuing it and reporting on it. For them, the challenge now is perhaps more how to measure the achievement of objectives and also how to value the benefits that their CSR commitments are yielding both to the business and the wider community, with a view to securing the best use of resources with best value results. For others, taking a more minimal approach, their response to date may be little more than compliance with law.

1.4.6 Increasing corporate governance activity in the financial sector

The so-called 'credit crunch', and the fallout from this in financial markets, has led to the potential for increased invasiveness on the part of Government and regulators.

On 9 February 2009, HM Treasury published a press release announcing that the Government has commissioned an independent review of corporate governance in the UK banking industry.

Sir David Walker will chair the review, which will report jointly to Alistair Darling, the Chancellor of the Exchequer; Peter Mandelson, the Business Secretary; and Paul Myners, the Financial Services Secretary. The review will present preliminary conclusions to these ministers in autumn 2009 and will make final recommendations by the end of 2009.

Announcing the review, the Chancellor said it was 'clear that corporate governance should have been far more effective in holding bank executives to account' while Lord Mandelson promised that the review would ensure that UK banks had 'competent, well-run and transparent boards which are engaged with their shareholders and capable of understanding and managing risk effectively'.

The review's terms of reference are to examine corporate governance in the UK banking industry and make recommendations, including in the following areas:

- the effectiveness of risk management at board level, including the incentives in remuneration policy to manage risk effectively;

- the balance of skills, experience and independence required on the boards of UK banking institutions;
- the effectiveness of board practices and the performance of audit, risk, remuneration and nomination committees;
- the role of institutional shareholders in engaging effectively with companies and monitoring of boards; and
- whether the UK approach is consistent with international practice and how national and international best practice can be established.

Overview of Corporate Governance Codes, Rules, Guidance and Other Publications

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2.1 The framework

In the UK, the regulation of corporate governance is provided by a number of different rules, regulations and recommendations. Broadly, they are:

- Common law (that is, case law relating, for example, to directors' fiduciary duties);
- Statute (notably the Companies Act 1985 and Companies Act 2006);
- The company's constitution, the memorandum and articles of association;
- The Financial Services Authority's Listing, Disclosure and Transparency Rules;
- The Combined Code on Corporate Governance, which applies to companies that are admitted to listing by the UKLA, including those whose shares are traded on the London Stock Exchange. Companies should include a statement in their annual financial reports indicating how they apply the compulsory principles of the Code. Its provisions are not mandatory but companies are required to include a second statement disclosing whether or not they comply with the Combined Code and give reasons for non-compliance. The Combined Code is supplemented by:
- The Turnbull Guidance, which is designed to assist listed companies in complying with the internal control requirements of the Code;
- FRC Guidance on Audit Committees (formerly known as the Smith Guidance);
- Suggestions for good practice from the Higgs review;
- Non-legal guidelines issued by bodies that represent institutional investors (such as the Association of British Insurers (ABI), the National Association of Pension Funds (NAPF) and the Pensions & Investment Research Consultants (PIRC)). These guidelines apply to listed companies and in some respects go further than the Code. Although the guidelines are informal, institutional investors may oppose any corporate actions that contravene them;

- In the context of takeovers of public companies, the City Code on Takeovers and Mergers and rules of the Takeover Panel apply.
- The Financial Services Authority's Code of Market Conduct regulates the disclosure and use of inside information, and actions that could create a false market, in each case in relation to listed company securities.

2.2 Recent UK developments

As well as the influences of Europe and the US, a number of developments within the UK in the past few years have had a significant impact on the corporate governance environment of today and will shape its future.

2.2.1 The Companies Act 2006 (2006 Act)

This Act received Royal Assent on 8 November 2006. It will be fully in force by October 2009, with certain provisions having taken effect from January 2007 and subsequent dates.

The 2006 Act included provisions to:

- Codify the duties of directors;
- Allow shareholders to agree to limit auditors' liability to the company, so their financial liability relates to their responsibility for the loss;
- Simplify the regime for private companies, for example, by making it easier for decisions to be taken by written resolution, and dispensing with the requirement for private companies to hold AGMs;
- Enhance the rights of proxies and make it easier for companies to enfranchise indirect owners of shares;
- Amend the share capital and capital maintenance provisions, for example, by abolishing the financial assistance provisions for private companies, introducing a new mechanism for capital reductions for private companies, and abolishing the requirement to have authorised share capital.

Under Part 43 of the new Act (which entered into force on passing of that Act), changes were made to the Financial

Services and Markets Act 2000 to give the Financial Services Authority power to make corporate governance rules (section 890, 2006 Act). The FSA has introduced corporate governance rules in its Disclosure and Transparency Rules, specifically DTR 7.

2.2.2 Corporate manslaughter

The Corporate Manslaughter and Corporate Homicide Act 2007 came into force on 6 April 2008. It creates a new statutory offence of corporate manslaughter replacing the common law offence of manslaughter by gross negligence as applied to companies. The Act applies to companies and other corporate bodies (in the public and private sectors), certain Government departments and police forces. The new offence does not create individual liability (directors and managers can be held to account through existing health and safety laws and the common law offence of manslaughter).

2.2.3 Listing, prospectus, disclosure and transparency rules

On 30 July 2002, the FSA began its process of modernising and simplifying the Listing Rules in the UK by publishing Discussion Paper 14: Review of the Listing Regime (DP14).

Following its three year review of the UK listing regime and in order to implement the Prospectus Directive and Market Abuse Directive, on 1 July 2005, a new block of the FSA Handbook known as the Listing, Prospectus and Disclosure Rules came into effect. To implement the Transparency Obligations Directive in the UK (see above), on 20 January 2007, three new chapters were introduced into the Disclosure Rules to become the Disclosure Rules and Transparency Rules. The Listing, Prospectus, Disclosure and Transparency Rules form a block of the FSA Handbook. This comprises three elements:

- Listing Rules: contain the Listing Principles, rules and guidance on listed companies' continuing obligations and the sponsors' regime.
- Prospectus Rules: these broadly replace Chapters 5, 6 and 8 of the old Listing Rules and contain rules and guidance on the requirements to publish a prospectus, the approval process and contents of a prospectus.

- Disclosure Rules and Transparency Rules: the Disclosure Rules contain rules and guidance on listed companies' obligations to disclose and control 'inside information' and notify transactions by persons discharging managerial responsibilities. The Transparency Rules broadly relate to major shareholdings and the notification and dissemination of information by issuers of transferable securities.

2.2.4 AIM companies

The Combined Code does not apply to companies quoted on AIM, but there is no formal alternative for AIM companies. To fill this void, on 13 July 2005, the Quoted Companies Alliance (QCA), the representative body for small and mid-cap quoted companies (formerly known as CISCO) published its first corporate governance guidelines for AIM Companies.

2.2.5 Shareholder activism

Recently, there has been an increase in demands made by institutional investors for better compliance with corporate governance recommendations; and there is increasing questioning of the competence of directors and the quality of their decisions.

The collapse of high profile companies and the introduction of a vote on directors' remuneration packages, means that institutional shareholders are now less content to sit back and wait for change, and are increasingly willing to call into question and even vote down company policies. An example of recent shareholder activism can be seen in the shareholders' revolt, in October 2003, which forced Michael Green to step down as chairman of Carlton so that an independent non-executive chairman from outside Carlton and Granada could be appointed chairman designate of the merged company of ITV plc. Such behaviour may be a sign of things to come, showing that institutional shareholders are more willing to flex their muscles and to declare their views more freely in the media.

The influence of institutional investors is not new in the corporate governance environment. Over the years, institutional

investor bodies have sought to combine the strength of their members through the publication of investment and voting guidelines. Institutional shareholder bodies are also becoming more sophisticated in their approach to corporate governance. For example, in 2004, NAPF, through its joint venture with US-based governance organisation Institutional Shareholder Services, launched a new web-based service for UK investors to give them access to analysis and recommendations on thousands of companies worldwide and enabling them to vote electronically. US and Canadian companies own about 30% of UK shares, so this service will strengthen NAPF's influence considerably.

2.3 The Higgs Review

In April 2002, the Higgs review of 'The role and effectiveness of non-executive directors in the UK' was established. The Higgs review addressed the following issues:

- The role that non-executive directors should perform.
- The knowledge, skill and attributes required for the role.
- Whether existing relationships with shareholders or others need to be supported.
- How non-executive directors can best be supported to perform their role?
- In what ways the position on the above is different for smaller listed companies?
- What can be learnt from international experience?

The final report of the Higgs review was published in January 2003. The report concluded that the fundamentals of UK corporate governance established by Cadbury and others were sound, and that the existing 'comply or explain' approach is effective.

The Higgs review proposed significant revisions to the Code aimed at clarifying the role of non-executives, their relationship with the rest of the board and with shareholders, their contributions to the remuneration and nomination committees, and how they are trained and paid. The report set out the recommendations of the review together with a draft revised

Code and a number of summaries and guidance notes for best practice.

Not all the proposals set out in the Higgs revised Code were welcomed. Many companies and commentators were critical of some of the more controversial proposals, in particular, the proposed role of the senior non-executive director, the proposals that the chairman should not chair the nomination committee, that chief executives should not become chairman of their companies, and the proposed changes to the length of tenure of non-executive directors. In light of these responses the Financial Reporting Council (FRC) set up a working group which produced the 2003 version of the Code in July 2003. The 2003 Code has now been superseded by the June 2006 version of the Code which is applicable to listed companies for reporting periods beginning on or after 1 November 2006 and before 29 June 2008. A further revised version of the Code (June 2008 version) applies to reporting periods beginning on or after 29 June 2008.

2.4 The Smith Report

In 2002, the FRC set up an independent group, chaired by Sir Robert Smith, to clarify the role and responsibilities of audit committees and to develop the existing Code guidance. This group worked closely with the Higgs review and in its report, Audit Committees: Combined Code Guidance (the Smith report) issued in January 2003, it proposed changes to provisions in the Code dealing with the composition and role of the audit committee and it's reporting to shareholders. The Smith report included specimen terms of reference for an audit committee and an outline of the section to be included in a company's annual report on the activities of the audit committee.

2.5 Investor group guidelines on CSR matters

In the last few years, various investor representative groups and others providing voting services have updated their

guidelines to make specific and more detailed reference to CSR matters. They state that they have done this because of growing investor awareness of the importance of such issues and growing investor demand for better management of these issues.

2.5.1 Association of British insurers

In January 2007, the Association of British Insurers (ABI) issued its Guidelines on Responsible Investment Disclosure (the Guidelines). These modify the ABI's Socially Responsible Disclosure Guidelines launched in 2001. The Guidelines are not intended to add to the reporting burden facing companies, but rather to help companies understand and respond to investors' needs when they set out to comply with the reporting requirements of UK and EC law.

The ABI wants the Guidelines to help companies to develop appropriate CSR policies and provide a constructive basis for engagement between companies and shareholders which, over time, will allow both to develop a clear, joint understanding of best practice in handling such matters that will help to preserve and enhance value.

The Guidelines list three aspects of narrative reporting on which institutional shareholders place particular value. This is narrative reporting which:

- Sets environmental, social and governance (ESG) risks in the context of the whole range of risks and opportunities facing the company.
- Contains a forward-looking perspective.
- Describes the board's actions in mitigating these risks.

The Guidelines then go on, in their disclosure guidelines, to list disclosures which institutions expect to see included in listed companies' annual reports, specifically relating to board responsibilities, policies, procedures and verification. To give but a flavour, the Guidelines mention:

- Regular risk assessment procedures by the board, taking account of the significance of ESG matters together with

disclosure of the process undertaken by the board to do this.

- Identification and assessment by the board of the significance of ESG risks to the company's short- and long-term value, as well as any opportunities to enhance value and possible impact on the future of the business.
- ESG matters to be taken account of in director training.
- The annual report to include information, where appropriate using Key Performance Indicators, about the extent to which the company has complied with its policies and procedures for managing material risks arising from ESG matters and about the board's role in providing oversight and where performance falls short of the objectives, describe the measures the board has taken to put it back on track.
- The annual report to describe the procedure for verification of ESG disclosures to achieve a reasonable level of credibility. Shareholders would see independent external verification as a significant advantage although credible verification could be achieved by other means (including internal audit).

  To help directors in deciding what to disclose in the annual report, the guidelines include an appendix of questions on ESG matters, the responses to which could be disclosed.

2.5.2 The National Association of Pension Funds

In November 2007, the National Association of Pension Funds (NAPF) launched its updated Corporate Governance Policy and Voting Guidelines. Reflecting NAPF's endorsement of the United Nations' Principles for Responsible Investment launched in April 2006, its guidelines for the first time include high-level guidance on ESG issues. In terms of the business review (generally and not only for ESG issues) they state that shareholders will wish the business review to:

- Be comprehensive yet succinct.
- Take a longer-term perspective.
- Contain pointers towards future development.

- Be easily understandable.
- Present good and bad news in a balanced way.
- Be comparable over time.
- Complement the financials.

2.5.3 PIRC

In its Shareholder Voting Guidelines 2008, PIRC launched its Governance Plus Rating Service, intended to provide a means of analysing a listed company's past performance on governance and CSR and their prospects for managing future governance and CSR risks effectively. For clients taking this service, the rating method they intend to use aims to identify the best 5% and the worst 5% of the companies surveyed (initially FTSE 100), with the former providing a benchmark for good practice and the latter a benchmark for the need for engagement.

2.6 The Combined Code

The Combined Code on Corporate Governance ('Combined Code') is probably the most important – or at least the most prominent – element of the UK's corporate governance regime. It is published by the Financial Reporting Council and is relevant to listed companies. The current version of the Combined Code (the 2006 version) came into force for companies with reporting periods beginning on or after 1 November 2006.

The Combined Code sets out standards of good practice, in relation to a variety of issues including the makeup and development of boards; board remuneration and accountability; company audit, and relationships with shareholders. It can be regarded as a codification of those standards regarded as best practice, from a corporate governance perspective.

The Combined Code is not law. However, all UK-incorporated companies which are listed on the main market of the London Stock Exchange are required by the Listing Rules to report, in

their annual Report and Accounts, on how they have applied the Combined Code – or, if they have not, to explain their non-compliance with it (the 'comply or explain' principle). Because it can be difficult for smaller companies to comply in full with the provisions of the Combined Code, some of those provisions are relaxed for companies which fall outside the FTSE 350 index.

Foreign companies listed on the London Stock Exchange are also required to disclose the significant ways in which their internal corporate governance practices differ from those set out in the Combined Code. The Combined Code can be found on the Financial Reporting Council website, at www.frc.org.uk.

The genesis of the Code arose from the outcome of three separate reports commissioned in the 1990s to consider different aspects of the then-emerging issue of corporate governance. These were:

- The Cadbury Report;
- The Greenbury Report; and
- The Hampel Report.

The Hampel Committee effectively combined the output from all three reports, hence the name of the original 'combined code'.

It has undergone various revisions as a result of other governance-related reviews, including:

- The Turnbull Report, which provided guidance to listed companies in connection with internal controls;
- The '*Review of the Role and Effectiveness of Non-Executive Directors*', commissioned by the DTI and otherwise known as the Higgs Report – published in January 2003; and
- The '*Audit Committees Combined Code Guidance*', otherwise known as the Smith Report – commissioned by the Financial Reporting Committee and also published in January 2003.

The reports themselves were prompted by various problems – and in some cases scandals – involving companies and their governance, including Enron and Worldcom. The facts of the

Enron Case, as they were seen at the time, are summarised here:

How the Enron scandal was reported at the time:

Source: BBC News Online, 2002 (http://news.bbc.co.uk/1/hi/business/1780075.stm)

"**The Enron scandal has far-reaching political and financial implications. BBC News Online reviews the key facts to help you make sense of developments.**

In just 15 years, Enron grew from nowhere to be America's seventh largest company, employing 21,000 staff in more than 40 countries. But the firm's success turned out to have involved an elaborate scam. Enron lied about its profits and stands accused of a range of shady dealings, including concealing debts so they didn't show up in the company's accounts. As the depth of the deception unfolded, investors and creditors retreated, forcing the firm into Chapter 11 bankruptcy in December. More than six months after a criminal inquiry was announced, the guilty parties have still not been brought to justice.

The investigators

A chorus of outraged investors, employees, pension holders and politicians are demanding to know why Enron's failings were not spotted earlier. And the US Justice Department is thought to be trying to charge several executives for fraud and money laundering. Prosecutors have come to a deal with one insider, Michael Kopper, who will plead guilty and spill the beans about Enron's murky finances. There is no date for a trial yet. There has already been a far-reaching investigation into the scandal by a number of congressional committees.

Three key players appeared involuntarily and then refused to speak in order to avoid incriminating themselves:

- ***Andrew Fastow:** Former chief financial officer, sacked as the scandal unfolded, and alleged author of the deceptive accounting practices.*

(*Continued*)

- ***Kenneth Lay:*** *Enron's former chief executive and chairman since 1986 refused to testify at the last moment after saying he had been pre-judged.*
- ***David Duncan:*** *Enron's chief auditor at Andersen who shredded key documents relating to the case. It was his job to check Enron's accounts.*

Three senior executives did testify:

- ***Joseph Berardino:*** *Andersen's chief executive, vigorously defended his firm's role in the affair.*
- ***Jeffrey Skilling:*** *Enron's chief executive in the first half of 2001 denied knowing that anything was wrong at the firm.*
- ***Sherron Watkins:*** *Enron employee and "whistleblower" of the scandal. She claimed that Ken Lay was 'duped' and placed the blame on Jeffrey Skilling and Andrew Fastow.*

In line for a sell-off

While investigations continue, Enron has sought to salvage its business by spinning off various assets. It has filed for Chapter 11 bankruptcy, allowing it to reorganise while protected from creditors. Former chief executive and chairman Kenneth Lay has resigned, and restructuring expert Stephen Cooper has been brought in as interim chief executive.

- *Enron's core business, the energy trading arm, has been tied up in a complex deal with UBS Warburg. The bank has not paid for the trading unit, but will share some of the profits with Enron.*
- *Centrica, part of the former British Gas, has bought Enron's European retail arm for £96.4m.*
- *Dynegy, a smaller rival, has won a key pipeline in the US after merger talks fell through. The pipeline was then resold to Warren Buffet.*
- *The power project in India's Maharashtra state - the biggest foreign investment project in India - is still for sale.*

In line for reform

That Enron's false accounting was not spotted sooner has prompted the accounting industry to take a hard look at itself. Hundreds of US firms which used so-called aggressive accounting methods to keep debts or one-off charges away from the headline figures have been affected. And Andersen, the former auditing giant, has collapsed after being found guilty of deliberately destroying evidence of its relationship with Enron.

President George W Bush has passed a tough new bill aimed at cracking down on corporate fraud.And he has also ordered a review of US pension regulations, after Enron employees lost billions of dollars because their pensions scheme was heavily invested in Enron's own stock. Other issues earmarked for attention by reformers include:

- *The role of business funds in political campaigning.*
- *The extent of energy companies' influence on national energy policy.*
- *Potential conflicts of interest between consultancy and auditing work.*
- *The need for tighter regulation on financial derivatives trading.*

Political implications

The scandal has also entered the political realm, because of Enron's close links with the White House. Enron provided millions of dollars to finance Mr Bush's 2000 election campaign.

Mr Bush was a personal friend of Mr Lay, but has been quick to distance himself from any involvement with the firm. It has also emerged that Mr Lay called two US cabinet officers before the company filed for bankruptcy late last year. And the US Treasury Department has said one of its officials felt he was asked to help Enron last year by company president Lawrence Whalley. Enron executives also met Vice President Dick Cheney and his

(*Continued*)

energy task force several times to discuss the administration's energy plan.

UK fallout

The British political repercussions of the Enron collapse centre around whether Labour's sponsorship from the company led to a change in government energy policy. Downing Street has dismissed allegations that the UK government is "enveloped in sleaze" over its links. Despite much mud slinging, there is no implication of guilt as yet. with Enron.

The Conservatives and Liberal Democrats are demanding an independent inquiry into what they say could be an affair about cash-for-access. Labour's relationship with Enron's accountants, Andersen, has also raised questions, especially as the firm was taken off the unofficial blacklist for government work, where it had been placed after the De Lorean car scandal in the early 1980s. The peer, a former Conservative energy minister, joined Enron as a non-executive director in 1994 and sat on the corporation's audit committee. Investigators say they do not believe Lord Wakeham was party to any fraud, but he could still face lawsuits from those who accuse him of failing to make public concerns about the energy giant''.

The Code is structured so as to include Main Principles, Supporting Principles and Code Provisions. Under the Listing Rules, the 'comply or explain' approach to the Combined Code remains (*LR9.8.6R(5) and 9.8.6(6)*). Thus, listed companies must include a statement in their annual financial reports stating how they have applied the principles of the Combined Code; this must cover both the Main and Supporting Principles of the Code. The Supporting Principles are drafted in general terms to allow companies the flexibility of deciding their own method of implementation.

The Code is divided into two main parts:

- Section 1 deals with the Main Principles relating to:
  - Directors;
  - Remuneration;
  - Accountability and Audit;
  - Relations with shareholders.
- Section 2 deals with three Main Principles relating to institutional shareholders. These three principles do not, therefore, fall within the 'comply or explain' regime discussed above, as it is the institutional investors in a company to which they apply – and not the company itself.

Various elements of the Turnbull, Higgs and Smith Reports are included as additional guidance and recommendations within the Combined Code.

2.6.1 Tailored versions of the combined code

Tailored versions of the Combined Code have been produced to various types of business interpret and apply it in the context of their own particular activities, or legal frameworks: for example, in July 2005 the Association of Mutual Insurers ('AMI') produced a version aimed at mutual insurance businesses, for just this purpose.

The AMI's document takes the form of an unamended transcript of the Combined Code text, supplemented by annotations to aid application in the context of that particular industry. The introduction to the document states that these annotations ''*follow a 'by exception' approach, in that they are given only for those elements of the Code that either raise particular issues, or are not considered to be relevant to mutual insurers''.*

The document can be found at http://www.mutualinsurers.org/documents/AMI-Combined-Code.pdf.

The AMI, together with the Association of Friendly Societies, became responsible for monitoring and reporting on compliance with the Annotated Code for affected firms, from their financial years ending after 1 January 2006.

In December 2005, the AMI then announced the publication of additional ‘guidelines’, to help its members comply with the above Annotated Combined Code of Corporate Governance (the Annotated Code). These guidelines were drafted as a response to the 2004 Myners’ report on the governance of UK mutual life insurance offices.

The guidelines are intended to promote ‘best practice’ in mutual insurers’ relations and communications with their members. They also include guidance on issues such as:

- Recruitment of directors;
- Development of directors;
- Reporting;
- Disclosure obligations.

They incorporate a questionnaire which insurers can use to help them draft their required disclosure statements – and which may also serve as a useful internal checklist for compliance with the requirements of the Annotated Code.

2.7 The FSA’s Listing, Prospectus, Disclosure and Transparency Rules

In order to implement the Prospectus Directive and the Market Abuse Directive into UK law, the FSA introduced a new block to its Handbook of rules on 1 July 2005: this was known as the Listing, Prospectus and Disclosure Rules. Its introduction also gave the FSA the opportunity to bring in changes resulting from a three-year review of the UK listing regime, which had raised corporate governance as a key area requiring policy development.

Following the publication of the Transparency Obligations Directive (Disclosure and Transparency Rules) Instrument 2006 (*FSA 2006/70*) to implement the Transparency Directive in the UK, three new chapters were introduced into the Disclosure Rules. This section of the FSA Handbook came into effect from 20 January 2007; it is known as the Disclosure Rules and Transparency Rules (and identified within the Handbook by the abbreviation DTR). It has three elements:

- **The Listing Rules** contain the Listing Principles, rules and guidance on listed companies' continuing obligations and the sponsors' regime.
- **The Prospectus Rules** broadly replace Chapters 5, 6 and 8 of the previous edition of the Listing Rules. They contain rules and guidance on the requirements for an issuer to publish a prospectus, the approval process for prospectuses and the contents of a prospectus.
- **The Disclosure Rules and Transparency Rules**: The Disclosure Rules contain rules and guidance on listed companies' obligations to disclose and control inside information, and to give notification of transactions undertaken by persons discharging managerial responsibilities. The Transparency Rules broadly relate to issues concerning major shareholdings, and to the notification and dissemination of information by issuers of transferable securities.

2.8 The Turnbull report

The Turnbull Report's full title is 'Internal Control: Guidance for Directors on the Combined Code'. It was published by the Financial Reporting Council (FRC), and is relevant to directors of listed companies.

The latest version of the Turnbull guidance was published in October 2005, and applies to listed companies for financial years beginning on or after 1 January 2006.

The Turnbull Report is the key source of corporate governance guidance for directors of UK listed companies. It addresses key areas such as disclosure, reporting and internal controls.

Among other things, Turnbull requires that, in the context of internal controls:

- A listed company's governing body (in general, this means its board of directors) acknowledges its responsibility for the company's system of internal controls;
- It implements ongoing processes for the identification, evaluation and management of significant risks;

- This system is reviewed for effectiveness annually;
- There are processes to deal with the internal control aspects of any significant problems which are required to be disclosed in the company's annual report and accounts;

In terms of assessing what constitutes a 'sound system of internal control', it states that the Board should consider:

- the nature and extent of the risks facing the company;
- the extent, and types, of risk which it regards as acceptable;
- the likelihood of those risks materialising;
- the company's ability to reduce the incidence and impact of those risks that do materialise.

The Turnbull Report also states that a company's system of internal controls should:

- be embedded in the operation of the company, and form a part of its culture;
- be able to respond quickly to evolving risks;
- include procedures for reporting any significant control failings immediately to appropriate levels of management.

2.9 The London Stock Exchange

In August 2004, the London Stock Exchange published 'Corporate Governance: a Practical Guide'. The guide was intended to give practical advice to listed companies, on how to implement the new Combined Code. It addresses areas such as:

- The selection and development of the Board of Directors;
- Succession planning;
- Ensuring effective teamwork;
- The types of issues to be considered by a Board in order to meet its aims of assisting a company in reaching its potential;
- Effective risk management;
- Communications with shareholders;
- Corporate social responsibility; and
- The approach to, and operation of, Board Committees.

As we have already noted, the Combined Code does not apply to companies which are not listed on the London Stock

Exchange. However, unlisted companies and AIM-listed companies can choose to comply with it voluntarily – in which case the LSE guidance will be of assistance to them.

2.10 The Association of Investment Companies ('AIC')

In 2003, the then Association of Investment Trust Companies (now renamed as the AIC) also issued a useful guidance document, a Code of Practice for directors of investment fund companies.

This document supplements the Combined Code; it is principles-based (as opposed to being made up of detailed rules), and like the Combined Code adopts a flexible, 'comply or explain' approach rather than a more prescriptive touch.

The Code of Practice highlights two specific factors distinguishing investment companies from other companies – and thereby creating a need for a different approach to corporate governance for them. The factors are:

- That the customers and shareholders of an investment company are the same; and
- That investment companies do not usually have employees. Consequently, the functions of the CEO, Company Secretary, investment management team, administration and accounting functions are generally fulfilled by third party fund managers or other delegees.

An investment company's fund manager thus plays a critical role in the operation of the investment company – and indeed may also hold one or more seats on the board, by way of its own personnel. This could, clearly, create significant conflicts of interest with the investment company's shareholders.

The Code of Practice aims to identify the interests of investment company shareholders' want, and the role their boards should play in achieving their objectives. Its key principles behind the code are that directors should:

- Put investor (i.e. shareholder) interests first;
- Treat all shareholders fairly;

- Be prepared to resign (or take steps that might lead to the loss of their board position), if it is in the long-term interests of the shareholders;
- Make sure that they consider all relevant issues;
- Make sure that they disclose matters in such a way that shareholders who are not financially-minded will still be able to comprehend them.

The Code of Practice has some recommendations regarding the way an investment company's Board should operate. These address:

- The conduct of meetings;
- The independence of the Board;
- Issues relating to disclosures;
- The use of Directors' service contracts;
- The requisite skills and training needs of the Board;
- The appointment and remuneration of the Board;
- The relationship of the Board with the investment company's fund manager, including contractual arrangements and performance reviews; and
- Shareholder communications, including – for example – the need to monitor the profile of the investment company's shareholder base.

In addition, the Code of Practice gives guidelines for Boards on how to apply the provisions of the Turnbull Report, and lists a number of firms offering independent director search services.

2.11 The Higgs review

In April 2002, and following on from the Company Law Review and the Myners review of institutional investment (*Institutional Investment in the UK, A Review, March* 2001), the Higgs review was established. In full, its title was *The role and effectiveness of non-executive directors in the UK*, and it addressed the following:

- The role that non-executive directors should perform;
- The knowledge, skill and attributes required for the role of non-executive director;

- Whether the non-executives need to provide support for existing relationships with shareholders or others;
- How non-executive directors can best be supported to perform their role;
- In what ways the above issues may be different for smaller listed companies; and
- What lessons can be learned from international experience.

The final report of the Higgs review was published in January 2003. It concluded that the fundamentals of UK corporate governance, as established by Cadbury and others, were fundamentally sound. It also expressed the view that the existing 'comply or explain' approach was working effectively.

The review proposed a number of significant revisions to the Code, chiefly aimed at clarifying the role of non-executives, their relationship with the rest of the board and with shareholders, their contributions to the remuneration and nomination committees, and how they should be trained and paid. As well as listing these recommendations, the report also included a draft revised Code and a number of summaries and guidance notes for best practice.

Some of the proposals set out in the Higgs-proposed revised Code were not particularly well-received: some commentators were critical, in particular, of the proposed role of the senior non-executive director, the proposals that the chairman should not chair the nomination committee, that chief executives should not become chairman of their companies, and of some proposed changes to the length of tenure of non-executive directors. In light of these responses, the FRC established a working group which produced the 2003 version of the Code in July 2003.

2.12 The Smith Report

In 2002, the Financial Reporting Council set up an independent group, chaired by Sir Robert Smith, to clarify the role and responsibilities of audit committees and to develop the existing Combined Code guidance in this area. The group worked closely with those working on the Higgs review.

The resulting report, *Audit Committees: Combined Code Guidance* (known for short as 'the Smith Report') was published in January 2003. It recommended changes to provisions in the Code, dealing with the composition and role of the audit committee and its reporting to shareholders.

The report included specimen terms of reference for an audit committee and an outline of the section to be included in a company's annual report on the activities of the audit committee.

Governance Post-Companies Act 2006, with Specific Reference to Shareholder Issues

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3.1 General

We have already, in the course of this book, noted a number of emerging trends relating to shareholders, and their information and other rights. Among these have been:

- As we saw in Chapter 1, an increase in calls for corporate social responsibility from investor representative groups. It remains to be seen how far these altruistic calls will extend into the current straitened economic environment – although it may be that they will be strengthened rather than reduced, as investors' patience with what may have been perceived as a culture of corporate greed is exhausted; and
- Statutory change, for example, the evolving 'enlightened shareholder value' approach enshrined in the directors' duties provisions of the Companies Act 2006, which we will look at in Chapter 4.

In this chapter we will focus mainly on those issues relating to governance in a shareholder context arising from the introduction of the Companies Act 2006 (the Act). The timelines in respect of these and other matters introduced by the Act are set out below.

3.1 Timetable of events

The Companies Act 2006 (the Act) is a substantial piece of legislation: it comprises some 1300 sections and 16 schedules and has been alleged to be the longest act ever to be passed by Parliament. Its complexity is such that in the final debate on what was then the Companies Bill, in the House of Lords on 2 November 2006, Lord Hodgson described it as having "*along the way caused the collapse of the traditional methodology used by the Public Bill Office for numbering amendments*". The final amendments considered by the House of Commons and Lords were, in the event, lengthier than the Financial Services and Markets Act 2000 – no mean feat!

This being the case, its provisions have been (and continue to be) brought into force over a considerable period of time (Table 3.1). In Table 3.2 you will find those yet to come into force as at February 2009, and the timeline for those already in place.

Table 3.1 Matters in force at the time of writing (February 2009)

31 October 2008	The Statutory Auditors and Third Country Auditors (Amendment) (No. 2) Regulations 2008 (amending the Statutory Auditors and Third Country Auditors Regulations 2007) came into force.
1 October 2008	The following came into force: ◆ Sections 69–74 (objection to company names). ◆ Sections 82–85 (trading disclosures). ◆ Sections 155–159 (provisions relating to corporate directors and underage directors). ◆ Sections 175–177, 180(1), (2) (in part) and (4) and 181(2) and (3) (general duties of directors on conflicts of interest). ◆ Sections 182–187 (declaration by a director of an interest in an existing transaction or arrangement). ◆ Part 14 (control of political donations and expenditure) – provisions relating to independent election candidates. ◆ Sections 641(1)(a) and (2)–(6), 642–644, sections 610(2)–(4), 652(1) and (3) and 733(5) and (6) so far as relating to a reduction of capital under the new solvency statement procedure for private companies, and 654 (share capital provisions in Part 17, mostly introducing the new solvency statement procedure for capital reduction for private companies). ◆ Part 37 (companies: supplementary provisions): section 1157. ◆ Part 44 (miscellaneous provisions): sections 1277–1280 (information as to exercise of voting rights by institutional investors). ◆ Certain provisions of Part 15 (accounts), Part 16 (audit) and Part 42 (statutory auditors) apply to Limited Liability Partnerships for financial years beginning on or after 1 October 2008. ◆ Paragraph 11(2) of Schedule 15 (amendment of definition of 'regulated market' in section 103(1) of the Financial Services and Markets Act 2000). ◆ Repeal of the restrictions under the Companies Act 1985 on the giving of financial assistance by a private company for the purpose of the acquisition of shares in itself or another private company, including the 'whitewash' procedure. ◆ Repeal of the prohibition on restoring to the register companies which were dissolved prior to 16 November 1969 (second sentence of section 141(4) of the Companies Act 1989). ◆ The Companies (Reduction of Share Capital) Order 2008.

	◆ The Companies (Trading Disclosures) Regulations 2008. ◆ The Company Names Adjudicator Rules 2008. ◆ The Companies Act 1985 (Annual Return) Regulations 2008. ◆ The Companies (Political Expenditure Exemption) Order 2007 in relation to support for an independent election candidate. ◆ The Large and Medium-sized Limited Liability Partnerships (Accounts) Regulations 2008. ◆ The Limited Liability Partnerships (Accounts and Audit) (Application of Companies Act 2006) Regulations 2008. ◆ The Small Limited Liability Partnerships (Accounts) Regulations 2008. ◆ The Companies (Forms) (Amendment) Regulations 2008. ◆ The Companies (Welsh Language Forms) (Amendment) Regulations 2008.
29 June 2008	The following came into force: ◆ Sections 1242–1244 of Part 42 and Schedule 12 (duties of third country auditors: information to be supplied by third country auditors). ◆ The Statutory Auditors and Third Country Auditors Regulations 2007 – regulations 32, 33 and 38(2)(b)–(d). ◆ The Statutory Auditors (Delegation of Functions etc) Order 2008 – Articles 4 and 9 come into force for the purpose of transferring the functions under sections 1242, 1243 and 1244 of, and Schedule 12 to, the Act (registered third country auditors) in relation to appointments of registered third country auditors for financial years beginning on or after 29 June 2008.
6 April 2008	The following came into force: ◆ Part 12 (company secretaries), and related to this, section 44 in Part 4 (execution of documents), other than sections 270(3)(b)(ii) and 275–279 (1 October 2009). ◆ Sections 121 and 128 in Part 8. ◆ Part 15 (accounts and reports), other than sections 417 (1 October 2007) and 463 (20 January 2007). ◆ Part 16 (audit), other than sections 485–488 (1 October 2007). ◆ Part 19 (debentures). ◆ Part 20 (private and public companies). ◆ Part 21 (certification and transfer of securities) and section 544 of Part 17 (transferability of shares). ◆ Sections 811(4), 812 and 814 (inspection of register of interests in a company's shares) in Part 22. ◆ Part 23 (distributions).

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- Part 26 (arrangements and reconstructions).
- Part 27 (mergers and divisions of public companies).
- Section 1126 (consents required for certain prosecutions).
- Sections 1161 and 1162 and Schedule 7 (meaning of 'undertaking' and related expressions), section 1164 (meaning of 'banking company' and 'banking group'), section 1165 (meaning of 'insurance company' and related expressions) and section 1169 (dormant companies).
- Section 1172 (references to requirements of this Act).
- In section 1173, the definitions of 'credit institution' and 'working day'.
- Part 42 (other than sections 1242–1244 – 29 June 2008) and Schedules 10, 11, 13 and 14 (statutory auditors).
- Section 1282 (payment of expenses of winding up) in Part 44.
- The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008.
- The Small Companies and Groups (Accounts and Directors' Report) Regulations 2008.
- The Companies Act 2006 (Amendment) (Accounts and Reports) Regulations 2008.
- The Bank Accounts Directive (Miscellaneous Banks) Regulations 2008.
- The Companies (Revision of Defective Accounts and Reports) Regulations 2008.
- The Companies (Defective Accounts and Directors' Reports) (Authorised Person) and Supervision of Accounts and Reports (Prescribed Body) Order 2008.
- The Companies (Summary Financial Statement) Regulations 2008.
- The Insurance Accounts Directive (Miscellaneous Insurance Undertakings) Regulations 2008.
- The Partnerships (Accounts) Regulations 2008.
- The Companies (Disclosure of Auditor Remuneration and Liability Limitation Agreements) Regulations 2008.
- The Statutory Auditors and Third Country Auditors Regulations 2007 (apart from regulations 32, 33 and 38(2)(b)–(d) – 29 June 2008).
- The Statutory Auditors (Delegation of Functions etc) Order 2008 (parts already in force on 1 March 2008).
- The Independent Supervisor Appointment Order 2007.
- The Companies (Fees for Inspection and Copying of Company Records) (No. 2) Regulations 2007.
- The Companies (Late Filing Penalties) and Limited Liability Partnerships (Filing Periods and Late Filing Penalties) Regulations 2008.
- The Accounting Standards (Prescribed Body) Regulations 2008.
- The Companies (Mergers and Divisions of Public Companies) (Amendment) Regulations 2008.

	◆ The Companies (Reduction of Capital) (Creditor Protection) Regulations 2008. ◆ The Companies (Authorised Minimum) Regulations 2008.
1 April 2008	The following came into force: ◆ Section 1175 (removal of special provisions about accounts and audit of charitable companies) comes into force for Great Britain but not for Northern Ireland (only for Part 1 of Schedule 9); and ◆ Part 1 of Schedule 9, in relation to accounts for financial years beginning on or after 1 April 2008. Section 1175 as it applies in Northern Ireland and Part 2 of Schedule 9 will not be commenced and will ultimately be repealed.
1 March 2008	The following Articles of The Statutory Auditors (Delegation of Functions etc) Order 2008. ◆ Articles 1 and 2. ◆ Articles 3, 6 and 8 for the purposes of functions in relation to appointments of auditors for financial years beginning on or after 6 April 2008.
6 February 2008	Deadline for comments on the government's consultation document on the application of the Act to LLPs.
14 January 2008	◆ Paragraph 2(5) of Schedule 5 to the Fifth Commencement Order inserted a new paragraph 23A into Schedule 3 to the Third Commencement Order which provides that where, immediately before 1 October 2007, a company's articles provided for the chairman to have a casting vote in the case of an equality of votes, that article remains effective notwithstanding sections 281(3) and 282 of the 2006 Act. Paragraph 23A also provides that companies which have removed such an article since 1 October 2007 may validly reinstate the article and benefit from the saving provision. ◆ Paragraph 2(4) of Schedule 5 to the Fifth Commencement Order inserted a new sub-paragraph 23(2) into Schedule 3 to the Third Commencement Order providing that, where extraordinary resolutions are still valid under the saving provision, such resolutions must be filed with the registrar of companies under Chapter 3 of Part 3 of the 2006 Act.
1 January 2008	The date by which indirect investors are entitled to enjoy information rights under Part 9 of the Act, unless the company elected to act on a nomination before that date.
31 December 2007	Paragraph 2(6) of Schedule 5 to the Fifth Commencement Order amended paragraph 32 of Schedule 3 to the Third

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	Commencement Order to provide that a private company need not hold AGMs, even if its articles expressly state that AGMs must be held, if an elective resolution under section 366A of the 1985 Act (dispensing with the need to hold AGMs) was in force immediately prior to 1 October 2007.
1 October 2007	The following came into force: ◆ Sections 29 and 30 (Part 3 – a company's constitution). ◆ Sections 116–119 of Part 8 apply to companies that have filed an annual return made up to a date after 30 September 2007, where the request to inspect the register is made on or after 1 October 2007. ◆ Part 9 (exercise of members' rights). Nominations of persons to enjoy information rights under section 146 may be made at any time on or after 1 October 2007, although companies had a grace period until 1 January 2008 to act on a nomination. If the company elected to act on a nomination before that date, sections 147–150 applied (*paragraph 3(2), Schedule 3, The Companies Act 2006 (Commencement No. 3, Consequential Amendments, Transitional Provisions and Savings) Order 2007 (Third Commencement Order).* ◆ Part 10 (a company's directors), other than: ◆ sections 155–159: 1 October 2008; ◆ sections 162–167: 1 October 2009; ◆ sections 175–177: 1 October 2008; ◆ sections 180(1), (2) (in part), (4)(b) and 181(2) and (3): 1 October 2008; ◆ sections 182–187: 1 October 2008; and ◆ sections 240–247: 1 October 2009. ◆ Part 11 (derivative claims and proceedings by members). ◆ Part 13 (resolutions and meetings) (other than sections 327(2)(c) and 330(6)(c) regarding proxies. ◆ Related to Part 13, sections 485–488 of Part 16 (audit). ◆ Part 14 (control of political donations and expenditure), other than the provisions relating to independent election candidates which came into force on 1 October 2008. ◆ Section 417 of Part 15 (content of directors' report: business review). ◆ Part 29 (fraudulent trading). ◆ Part 30 (protection of members against unfair prejudice). ◆ Part 32 (company investigations: amendments). ◆ The Companies (Fees for Inspection and Copying of Company Records) Regulations 2007. ◆ The Companies (Political Expenditure Exemption) Order 2007, other than as it applies to support for an

	independent election candidate, which comes into force on 1 October 2008. ◆ The Companies (Interest Rate for Unauthorised Political Donation or Expenditure) Regulations 2007 for the purpose of their application to Great Britain. ◆ The Companies (Tables A–F) (Amendment) Regulations 2007.
30 September 2007	The following came into force: ◆ Section 1137(1), (4), (5)(b) and (6) (regulations about inspection of company records and provision of copies: fees). ◆ Section 1167 (meaning of 'prescribed'). ◆ Section 1284 (extension of Companies Acts to Northern Ireland) so far as necessary for the purposes of the sections referred to above.
24 September 2007	Deadline for comments on the government's consultation document on the registration of Scottish floating charges under the 2006 Act.
31 May 2007	Government launched a consultation on the registration of Scottish floating charges under the Companies Act 2006.
31 May 2007	Deadline for comments on the government's consultation document on the policy issues relating to secondary legislation which will need to be made under the Act, and on transitional and savings provisions (other than comments on political donations and expenditure which had to be received by 1 May 2007).
1 May 2007	Deadline for comments on the government's proposals on political donations and expenditure, as requested in its consultation document published on 28 February 2007.
20 April 2007	Issuers had to notify a Regulated Information Service of any DTR 5 notifications received by the 20 March 2007 deadline.
6 April 2007	The following provisions of the Companies Act 1985 were repealed: ◆ Section 41 (authentication of documents). ◆ Sections 293 and 294 (provisions relating to directors aged 70 and over in public companies or private companies which are subsidiaries of public companies). ◆ Section 311 (prohibition on tax-free payments to directors). ◆ Sections 323–329 (provisions relating to the disclosure of share dealings by directors and their families) (and Parts 2–4 of Schedule 13). ◆ Sections 343 and 344 (special procedure for disclosure of dealings in favour of directors by banks).

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	◆ Sections 428–430F (compulsory acquisition procedure on a takeover), although there was a saving provision (where the offer document was posted before 6 April 2007 and the offer is one to which sections 428–430F would apply, these provisions still apply after 6 April 2007). ◆ Section 438 (a power for the Secretary of State to bring civil proceedings on a company's behalf) and section 453(1A)(b). ◆ Section 720 (a requirement for certain companies, including insurance companies, to publish periodical statements) (and Schedule 23). ◆ Section 729 (a requirement that the Secretary of State shall prepare an annual report to parliament of matters within the Companies Acts). ◆ Section 744, the definition of 'EEA State'. ◆ Paragraphs 2, 2A and 2B of Schedule 7 (relating to disclosure in the directors' report of a director's interests in shares). The Takeovers Directive (Interim Implementation) Regulations 2006 (*SI 2006/1183*) were repealed, although there was a saving provision (where the offer document was posted before 6 April 2007 and the offer was one to which the compulsory acquisition procedures in the Regulations would apply, those provisions still apply after 6 April 2007). Regulation 8(2)(b) also continues to operate in respect of offences committed prior to 6 April 2007.
6 April 2007	The following came into force: ◆ Section 2 (The Companies Acts). ◆ The provisions in Part 28 of the Act implementing the Takeovers Directive. ◆ Provisions extending the community interest company regime to Northern Ireland. ◆ Section 1043 (unregistered companies). ◆ Section 1281, which amended Part 9 of the Enterprise Act 2002 to enable public authorities, in certain circumstances, to disclose information where the information is to be used in civil proceedings or otherwise for the purpose of establishing, enforcing or defending legal rights. ◆ The provisions about fees payable to Companies House under the new Act (the provisions about fees under the Companies Act 1985 will remain in force until all the repeals of provisions in that Act have been brought into force). ◆ Protection for members of LLPs who have been granted confidentiality orders from having their details open to inspection on the public register, which was

	inadvertently removed by the first commencement, was been restored. ◆ The Companies Acts (Unregistered Companies) Regulations 2007, extending certain provisions of the Act regarding takeovers to unregistered companies, to further effect implementation of the Takeovers Directive together with commencement of Part 28 of the Act.
20 March 2007	A person with a notifiable percentage of the voting rights of an issuer within the scope of DTR 5 was required to notify the issuer by this date of the percentage of voting rights he held unless he had already made a notification under DTR 5 (for example, if his holding had gone through a DTR 5 threshold after 20 January 2007). Note that persons had to notify their holdings even if these were previously notified under the Companies Act 1985 provisions.
28 February 2007	Government announcement of detailed timetable for implementation of the Act and published a consultation document on the policy issues related to secondary legislation which would need to be made under the Act, and on further transitional issues.
20 January 2007	The following provisions came into force: ◆ Provisions on company communications with shareholders and others, including electronic communications. ◆ Provisions concerning a public company's right to investigate who has an interest in its shares. ◆ Section 463, which sets out a statutory basis of directors' liability to the company in relation to the directors' report (including the business review) and the directors' remuneration report. ◆ All powers under the Act to make orders or regulations by statutory instrument.
20 January 2007	The Transparency Directive was implemented in the UK. The FSA's Disclosure Rules and Transparency Rules sourcebook came into force.
20 January 2007	Companies within the scope of DTR 5 to update their statement of voting rights for each class of shares admitted to trading if there have been any changes since the notification required by 31 December 2006 (for example, if a company has bought back any shares either for cancellation or to be held in treasury).
19 January 2007	This is the last day on which market makers had to report their substantial shareholdings to the London Stock Exchange in accordance with Rules 2300–2302. These

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	rules were removed with effect from 20 January to reflect the exemption granted to market makers for holdings up to 10% in the Disclosure Rules and Transparency Rules sourcebook.
1 January 2007	Provisions came into force on electronic disclosure of company documents and the requirement to state the company's name, registered number, place of registration and registered office address on the company's website and its order forms. These regulations implement the First Company Law Amendment Directive (*2003/58/EC*) and apply to all companies. The DTI also published an implementation briefing on the regulations implementing the First Company Law Amendment Directive.
29 December 2006	Companies within the scope of Chapter 5 of the FSA's Disclosure Rules and Transparency Rules sourcebook (DTR 5) (broadly (i) UK companies and other companies whose home member state is the UK with securities admitted to a regulated market and (ii) UK companies with securities traded on AIM or PLUS Markets) were required to release to a Regulated Information Service by 13.30 on this date; details of the total number of voting rights for each class of issued share capital admitted to trading on a regulated market or a UK prescribed market. They also had to identify the number of voting rights attached to shares held in treasury. This disclosure was required to be made by 31 December but the effective deadline was 13.30 on 29 December as the RISs were not open to release announcements between 13.30 on 29 December and 7.00 on 2 January 2007.
22 December 2006	The Financial Services Authority published the transparency rules in final form to be incorporated in its Disclosure Rules and Transparency Rules sourcebook with effect from 20 January 2007. This followed the special edition of List! Published on 20 December giving an overview of the new requirements.
8 November 2006	Companies Act 2006 received royal assent. The following provisions of the Act commenced on royal assent: ◆ Part 43 of the Act which inserts provisions to implement the Transparency Directive into Part 6 of the Financial Services and Markets Act 2000 (FSMA). Under amended Part 6, the Financial Services Authority (FSA) has power to make transparency rules relating to the disclosure of major holdings of voting rights (these will replace the major shareholding provisions in Part VI of

the Companies Act 1985). The transparency rules will be inserted in the FSA's Disclosure Rules sourcebook that will be renamed the Disclosure Rules and Transparency Rules sourcebook. The changes to Part 6 of the FSMA included a change to the definition of transferable securities in s102A of the FSMA and introduced a new definition of debt securities into the same section.

Part 43 inserts additional provisions into Part 6 of the FSMA including:

- a new section 89O giving the FSA power to make corporate governance rules (note also section 1273 of the Act which gives the Secretary of State power to make corporate governance regulations to implement any EU obligation);
- a new section 90A dealing with liability for false or misleading statements in financial reports required by the Transparency Directive and any preliminary statement of a company's final results; and
- a new section 100A dealing with the exercise of the FSA's powers following a breach of the prospectus rules or the transparency rules where the UK is the host member state.

- The extension of section 16 of the Companies (Audit, Investigations and Community Enterprise) Act 2004 (2004 Act) (which provides for grants to bodies concerned with accounting standards, such as the Financial Reporting Council) to cover grants to bodies concerned with actuarial standards.
- The amendment of section 16 of the 2004 Act in its application in Scotland, and the extension of sections 16 and 18 of that Act to Northern Ireland.
- The general provisions in the Act about regulations and orders, consequential and transitional provisions, continuity of law between existing law and the new Act and the territorial extent and coming into force of the new Act.

3.2 Background to the Companies Act 2006

In 1998, the Company Law Review was established, with a view to making recommendations for the simplification and modernisation of company law across a wide spectrum. Amongst its final recommendations, published in 2001, was the statutory codification of directors' general duties so as to reflect existing law – the aim being to give clarity on what is expected of directors, and to make the law more accessible.

Table 3.2 Matters not yet in force at the time of writing (February 2009)

Date	Event/action
1/10/10	Those companies with no natural person as a director on 8 November 2006 have until now to appoint at least one.

1/10/09	The following come into force:
	◆ Part 1 (general introductory provisions), other than section 2 (6 April 2007).
	◆ Part 2 (company formation).
	◆ Part 3 (a company's constitution), other than sections 29 and 30 (1 October 2007).
	◆ Part 4 (a company's capacity and related matters), other than section 44 (6 April 2008).
	◆ Part 5 (a company's name) (although sections 69–74 and 82–85 came into force on 1 October 2008).
	◆ Part 6 (a company's registered office).
	◆ Part 7 (re-registration as a means of altering a company's status).
	◆ Part 8 (a company's members), other than sections 121 and 128 (6 April 2008), although sections 116–119 on access to a company's register of members apply where the request is made on or after 1 October 2007 and the company has filed an annual return made up to a date after 30 September 2007.
	◆ Part 10 (a company's directors):
	  ◆ sections 162–167 (directors' particulars to be registered);
	  ◆ sections 240–246 (directors' residential addresses);
	  ◆ section 247 (power to make provision for employees on cessation or transfer of business);
	The provisions relating to underage and natural directors (*sections 155–159*), directors' conflict of interest duties (*sections 175–177, 180(1), (2) (in part) and (4)(b), 181(2) and (3)*) and declaration of interest in existing transaction or arrangement (*sections 182–187*) were implemented on 1 October 2008.
	◆ Section 270(3)(b)(ii) and sections 275–279 (particulars of secretaries to be registered) in Part 12.
	◆ Part 17 (a company's share capital) other than the sections relating to the new procedure for private companies to make capital reductions supported by a solvency statement instead of by a court order, which came into force on 1 October 2008.
	◆ Part 18 (acquisition by limited company of its own shares).
	◆ Part 24 (a company's annual return).
	◆ Part 25 (company charges).
	◆ Part 31 (dissolution and restoration to the register).

- ◆ Part 33 (UK companies not formed under the Companies Acts) other than section 1043 (6 April 2007).
- ◆ Part 34 (overseas companies).
- ◆ Part 35 (the registrar of companies), other than section 1063 (6 April 2007) and sections 1068(5), 1077–1080, 1085–1092, 1102–1107 and 1111 (all 1 January 2007).
- ◆ Part 36 (offences under the Companies Acts) other than section 1124 (1 October 2007) and section 1126 (6 April 2008).
- ◆ Part 37 (company records, service addresses, independent valuation) other than section 1137(1), (4), (5)(b) and (6) (30 September 2007), sections 1143–1148 (20 January 2007) and section 1157 (1 October 2008).
- ◆ Part 38 (companies: interpretation) other than sections 1161, 1162, 1164, 1165, 1169 and 1172 (6 April 2008), section 1167 (30 September 2007) and section 1170 (6 April 2007).
- ◆ Part 39 (companies: minor amendments): sections 1180 and 1181 (section 1175: 1 April 2008).
- ◆ Part 40 (company directors: foreign disqualification etc).
- ◆ Part 41 (business names).
- ◆ Part 44 (miscellaneous provisions): sections 1275 and 1283.
- ◆ Part 45 (Northern Ireland).
- ◆ The Companies (Shares, Share Capital and Authorised Minimum) Regulations 2008.
- ◆ The Companies (Reduction of Capital Regulations) 2008.
- ◆ The Companies (Registration) Regulations 2008.
- ◆ The Companies Act 2006 (Annual Return and Service Addresses) Regulations 2008.
- ◆ The Companies (Disclosure of Address) Regulations 2009.
- ◆ The Companies (Particulars of Company Charges) Regulations 2008.
- ◆The Companies (Company Records) Regulations 2008.
- ◆ The Companies (Fees for Inspection of Company Records) Regulations 2008.
- ◆ The Registrar of Companies and Applications for Striking Off Regulations 2008 (these regulations were withdrawn on 11 December 2008 and a revised draft will be submitted to Parliament early in 2009).
- ◆ The Companies (Unregistered Companies) Regulations 2008.
- ◆ The Non-Companies Acts Companies Authorised to Register Regulations 2008.
- ◆ The Companies (Model Articles) Regulations 2008.
- ◆ The Company and Business Names (Miscellaneous Provisions) Regulations 2008.
- ◆ The Overseas Companies Regulations 2008.
- ◆ The Companies (Trading Disclosures) (Amendment) Regulations 2009.
- ◆ The Companies House Trading Fund (Amendment) Order.

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	◆ The Limited Liability Partnerships (Application of Companies Act 2006) Regulations 2009. ◆ Regulation 11 of The Companies Act 2006 (Accounts, Reports and Audit) Regulations 2009. All parts of the Act will have come into force (apart from sections 327(2)(c) and 330(6)(c), which are not being commenced.
3 August 2009	The following proposed new sections of the Act are expected to come into force, as part of the implementation of the Shareholders' Rights Directive: ◆ A substituted section 285 (voting by proxies) and new section 285A (voting rights on poll or written resolution). ◆ Section 322A (voting on a poll: votes cast in advance). ◆ Section 323(5), along with amendments to section 323(4) (representations of corporations at meetings). ◆ Section 324A (obligation of proxy to act in accordance with instructions). ◆ Section 360A (electronic meetings and voting). ◆ Section 307A (notice required of general meeting: traded companies). ◆ Section 311A (traded companies: publication of information in advance of general meeting), along with amendments to section 311 (contents of notices of meetings). ◆ Section 319A (traded companies: questions at meetings). ◆ Amendments to a number of sections in relation to traded companies (*sections 327, 330, 333, 336–341, 352*) ◆ Section 338A (traded companies: members' power to include other matters in business dealt with at AGM). ◆ Section 340A (traded companies: duty to circulate members' items for AGM). ◆ Section 360B (traded companies: share dealings before general meetings). ◆ Section 360C (meaning of 'traded company'). BERR is consulting on the introduction of these new sections, therefore the section numbers (and drafting of the sections) may change once BERR has received responses to its consultation.
6 April 2009	The Companies Act 2006 (Accounts, Reports and Audit) Regulations 2009 will come into force apart from regulation 11 (1 October 2009). For financial years beginning on or after 6 April 2009, quoted companies will have a new requirement to state in their directors' remuneration report how they have taken pay and employment conditions elsewhere in the group into account when setting directors' pay (*paragraph 4, Schedule 8, The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008*).

These essential objectives were, in the event, adopted in the proposals which ultimately led to the Companies Act 2006 (the Act).

Part of the reason for the new Act's prodigious size is that it represents a consolidation measure: that is, it repeals and restates much of the pre-existing company law. When it was initially conceived, the intention was that on enactment, the Act would exist alongside the amended Companies Acts 1985 and 1989. However, in June 2006 Government stated its intention to consolidate further provisions of the 1985 and 1989 Companies Acts into the Act whilst it passed through Parliament – the aim being to arrive at a single, more comprehensive codification of company law. As a result, not a great deal is left behind in the Companies Acts 1985 and 1989 and the Companies (Audit, Investigations and Community Enterprise) Act 2004. Indeed, the old Department of Trade and Industry (now the Department for Business, Enterprise and Regulatory Reform, or 'BERR') has seen fit to publish a summary of what provisions do survive in those Acts. They include:

- Some Scots (non-company) law provisions which are now devolved to, and have been replaced by, the Scottish Parliament;
- The self-standing provisions on community enterprise companies, and those provisions relating to investigations which have wider application than for companies alone;
- Provisions about the Financial Reporting Council, its operation and its subsidiaries;
- Provisions about assisting overseas regulatory authorities in relation to financial markets, and about the Financial Reporting Review Panel, and insolvency, all in the context more of financial services than general company law.

The new Act provides three sets of model articles:

- one for private companies limited by shares;
- one for private companies limited by guarantee; and
- one for public companies.

This is in contrast to the previous provisions, which offered a single set of model articles for all companies limited by

shares (known as 'Table A' Articles). These were settled only relatively recently – on 23 December 2008, the Office of Public sector Information ('OPSI') published the final Companies (Model Articles) Regulations 2008 (SI 2008/3229). These contained the versions of the model articles to be used from 1 October 2009.

In the meantime, an 'interim Table A' may be sued between 1 October 2007 and 1 October 2009 (when the final articles come into effect). Table A has in effect been amended to reflect the provisions on resolutions and meetings of the Act that came into force on 1 October 2007, and those other provisions of the Act that are already in force.

Various provisions in the Act have needed to be detailed in secondary legislation – mostly by way of regulations or orders made by statutory instrument. The Act grants several powers to make secondary legislation, not all of which the Government chose to exercise on commencement of the Act. Again, BERR published a list (as part of its consultation paper) of the various powers under the Act and of which were to be exercised at outset. Many regulations have already been published and made, and but some are still in draft form.

We will take a look now at various governance matters relating to shareholders, dealt with under the Act.

3.3 Key shareholder issues under the Act

Among the key changes relevant for shareholders of companies, which came into force on 1 October 2007 as a result of the Act, are those relating to:

- **Proxies.** The new Act has given proxies (and in particular the proxies of shareholders of public companies) enhanced rights. Section 324 of the Act gives members of both private and public companies the right to appoint a proxy to attend, speak and vote at meetings on their behalf. It also permits a member to appoint more than one proxy in relation to a meeting, provided that each proxy is appointed to exercise the rights attached to a different share or shares held by him, or to a different £10, or multiple of £10, of stock held by him.

- The Act makes it clear that the company's articles can give more extensive rights regarding proxies than the minimum set out in the Act. Sections 324–331 of the Act (other than sections 327(2)(c) and 330(6)(c) which will not now be commenced and will ultimately be repealed; see Statement by The Parliamentary Under-Secretary for Business, Enterprise and Regulatory Reform) apply to meetings for which notice is given on or after 1 October 2007.
- **Written resolutions.** It is still the case under the Act that only private companies can pass written resolutions. This means that public companies that are wholly-owned subsidiaries will not be able to use the written resolution procedure under the Act to take decisions.
- Private companies now have the ability to pass:
  - written ordinary resolutions by a simple majority of those eligible to vote and
  - written special resolutions with a 75% majority of those eligible to vote,

rather than requiring unanimity for all types of written resolution as was the case under the 1985 Act.

Procedural details covering the circulation of, and timing for the passing of, written resolutions are included in the Act in much greater detail than was the case under the provisions of the Companies Act 1985. Sections 288–300 of the new Act apply to all written resolutions for which the circulation date is on or after 1 October 2007.

- **Short notice**. The requisite majority from whom consent to the holding of a meeting on short notice needs to be obtained by private companies has been reduced under the Act, to 90% of the nominal value of voting shares or such higher percentage (not exceeding 95%) as may be specified in the company's articles.

3.4 Other shareholder issues

Other more minor, but nonetheless important issues, include:

- **Notice period.** The notice period for all general meetings of a company (other than for AGMs of a public company) is now 14 days under the new Act, regardless of the type of

resolution proposed to be passed at the general meeting. This contrasts with the situation as it was under the Companies Act 1985, where there was a notice period of 21 days where a special resolution was to be proposed at the general meeting. This change came into effect on 1 October 2007 in relation to meetings of which notice was given on or after 1 October 2007.

- **Register of members.** The new Act introduces new measures modifying the right to inspect, and be provided with copies of a company's register of members. Those seeking to inspect, or to be provided with a copy of, the register of members must first supply their name and address, the purpose for which the information will be used, and – if the information will be disclosed to any other person – the same information relating to that other person. Companies are provided with a right to refer a request (for inspection or a copy) to the court if they think that the request may not have been made for a 'proper purpose'. If the court is satisfied that the access to the register of members is not sought for a proper purpose, it will relieve the company of the obligation to meet the request. As the Act does not define 'proper purpose', the Institute of Chartered Secretaries and Administrators (ICSA) has published an updated guidance note on the proper purpose test that should be applied to requests for access to a company's register under section 116. The guidance note gives examples of what should constitute a proper purpose, and what is likely to be regarded as an improper purpose.
- Once a company has filed an annual return made up to a date after 30 September 2007, it will be subject to the Act's provisions relating to access to its register of members where the request is made on or after 1 October 2007 (sections 116–119 of the Act).
- The Secretary of State has made regulations under the Act that allow a company to keep its register of members (and certain other registers and records) available for inspection at a place other than its registered office (the place must be the same for all such registers and records), which will come into force on 1 October 2009, state that a company may keep its register of members at a **single** alternative

location, situated in the same part of the UK as the company's registered office (and for this purpose, part of the UK means England and Wales, Wales, Scotland or Northern Ireland).

- **Institutional disclosure of voting**. The Secretary of State has a reserve power under the Act to make regulations requiring that institutional investors disclose information about the exercise of voting rights attached to shares in which they have an interest. The aim is to encourage institutional investors who don't currently disclose voting information to adopt the 'best practice' of voluntary disclosure, thereby leading to greater transparency in voting. The power will provide a back-up in the event that the voluntary disclosure regime does not continue to develop as it has been doing. Sections 1277–1280 of the Act came into force on 1 October 2008.

3.5 Information Rights

Part 9 of the Act, which came into force on 1 October 2007, has introduced new provisions whereby companies can provide in their articles for members to nominate other persons to enjoy or exercise their rights as a member (section 145 of the new Act). These members' rights include the right to:

- be sent proposed written resolutions;
- require circulation of a written resolution;
- require directors to call a general meeting;
- receive notice of general meetings;
- appoint a proxy to act at a meeting;
- require circulation of a resolution for an AGM of a public company;
- be sent a copy of the annual accounts and reports.

Those nominated to enjoy such rights will not be able to enforce their rights directly against the company. The registered member has to enforce the rights through the articles. Also, only the registered member can validly transfer shares.

A member who holds shares on behalf of others in companies whose shares are admitted to trading on a regulated market

may nominate the person on whose behalf he holds the shares (that is, the beneficial owner) to enjoy certain 'information rights'. The member may only nominate another to enjoy these information rights in their entirety; a nomination purporting to relate to certain information rights only is ineffective.

The company may make an enquiry, once a year, as to whether the nominated person wishes to retain information rights. If no response to this enquiry is received within 28 days, the nomination will cease to have effect.

Nominations of persons to enjoy information rights under section 146 of the Act have been able to be made at any time on or after 1 October 2007, although companies had a grace period until 1 January 2008 to act on a nomination. If the company elected to act on a nomination before that date, sections 147–150 of the Act applied.

In the next chapter, we will see how the new Act has affected corporate governance in other areas – with specific reference to directors' duties.

A Practical Guide to Establishing a Framework

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Corporate Governance Post-Companies Act 2006, Part 2

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In this chapter we will consider those areas of governance impacted by the Companies Act 2006, other than those we examined in Chapter 3. We will pay particular attention to matters affecting directors.

4.1 Electronic communications provisions

The communications provisions in the Act in sections 308, 309, 333, 1143–1148 and Schedules 4 and 5 came into force on 20 January 2007. They apply to all private and public companies.

Note – those companies whose securities are admitted to trading on a regulated market – for example, the London Stock Exchange but *not* AIM – will **also** need to comply with the communication requirements in Chapter 6 of the Financial Services Authority's 'Disclosure Rules and Transparency Rules' sourcebook (abbreviated as DTR 6 and forming part of the FSA's Handbook of Rules). These also came into force on 20 January 2007, to implement the EU Transparency Directive.

Important changes in the area of electronic communications, made under the Act, include the following:

- Part 13 of the Act incorporates a new provision which allows a shareholder to communicate with his investee company by electronic means where the company has given an electronic address in a notice calling a meeting or in an instrument of proxy or proxy invitation;
- Schedule 5 of the Act permits companies to send or supply documents and information to shareholders in electronic form and by a website (subject to shareholder approval);
- If a company already has an individual shareholder's agreement to circulate the annual report and accounts, summary financial statement or AGM notice to its shareholders by website under the terms required by sections 238, 251 or 369 of the Companies Act 1985, then such a company will be able to continue doing so by virtue of paragraph 9(a) of Schedule 5 to the Act (*agreement to accept documents or information by means of a website*)
- If a company already has an individual shareholder's agreement, and his electronic address, in order to circulate

the annual report and accounts, summary financial statement or AGM notice to him in accordance with sections 238, 251 or 369 of the Companies Act 1985, the company can to continue to do this by virtue of paragraph 6(a) of Schedule 5 of the Act (*agreement to accept documents or information in electronic form*).

The transitional provision relating to the FSA's Disclosure and Transparency Rules (rule DTR 6.1.8(1)) means that issuers need not a resolution in general meeting to use 'electronic means' to the extent that the issuer could lawfully use such means before 20 January 2007 – such companies can, therefore, continue relying on their existing authority. (Note that DTR 6 does not make a distinction between communications in electronic form and by a website in the same way as under the Act. DTR 6 refers to communications by 'electronic means' which could in theory include both email and use of a website.)

Some companies will have needed to propose amendments to their articles of association at their 2007 AGMs, or if they did not, may still need to do so, so as to:

- Let the company communicate with its members via a website where the articles do not already allow this; or
- Let it go further than the terms of its articles (for example, where the articles only covered certain documents, an amendment might be required to cover other documents that it wants to communicate by a website).

Companies whose securities are admitted to trading on a regulated market will have needed to (or will need to) need to obtain shareholder approval in general meeting to communicate by electronic means, should they not already have the appropriate arrangements in place under the Companies Act 1985 – or, of course, if they wish to extend their current arrangements, for example to cover a wider range of documents.

Unless the member is itself a company deemed to have agreed to receive documents or information in electronic form by a provision in one of the Companies Acts, a request letter will need to be sent to each member of the company asking for

his/its agreement to receive documents or information in electronic form. This request may be put as a general one, or with reference to specific documents. Each member must also be asked to supply an electronic address for this purpose and each member's individual consent will be needed if satisfactory existing arrangements are not in place already.

A request letter should also be sent to each individual member – and, if applicable, each debenture holder – asking them to agree that the company may send or supply documents or information (either generally, or specific documents and information) to them by way of a website, if satisfactory existing arrangements for website communication are not already in place. If the company receives no reply from the member/debenture holder within 28 days of the date when it sent its request to use a website as the means of communicating, the member/debenture holder will be deemed to have consented to receiving documents or information in that manner.

If a member/debenture holder replies within the 28-day period, the company will still have to send him hard copies. Note that there is no similar 'deemed consent' for the use by the company of electronic forms (e.g., email), such that if the member does not agree to the request, or fails to provide an email address, hard copy form must still be used by the company.

If he has consented or been deemed to consent, the member/debenture holder must still be notified of the presence of documents or information on the website, along with the website address, the place on the website where they can be accessed, and how to access them. Notification must be made by post unless the member/debenture holder has agreed to receive it by email or another form of electronic communication, and has supplied an appropriate address. He will still be entitled to request a hard copy of the document or information.

4.2 Interaction of the act with the Transparency Directive

The Transparency Directive was implemented in the UK on 20 January 2007. It happened thus.

Part 43 of the Act came into force – that is, on 8 November 2006, when the Act as a whole received Royal Assent. Part 43 of it amended Part 6 of the Financial Services and Markets Act 2000, allowing the FSA to make the transparency rules necessary to implement the EU Transparency Directive (by way of the implementation of the aforementioned Disclosure and Transparency Rules or DTR). The DTR themselves thus came into force on 20 January 2007, giving effect to the Directive.

Implementation of the Transparency Directive has involved changes to a number of regimes, including:

- The periodic financial reporting rules for companies with financial periods starting on or after 20 January 2007 (DTR 4);
- The regime for disclosing major shareholdings (although previous 1985 Act thresholds of 3% and every 1% thereafter will be retained) (DTR 5);
- The way companies communicate with shareholders and the market (DTR 6).

Also on 20 January 2007, the provisions in Part VI of the Companies Act 1985 (that is, sections 198 to 220) were repealed. These provisions were replaced from that date as follows:

- In part by the new regime for notification of major proportions of voting rights in DTR 5 and
- In part by provisions in Part 22 of the Act relating to a public company's right to investigate who has an interest in its shares. Part 22 has not made any major amendments to the regime under the Companies Act 1985 which enabled a public company to investigate interests in its shares, but a company can now serve notice in electronic form as well as in writing. The section 212 notice has been replaced by a section 793 notice.

4.3 The statutory liability regime

The new Act introduced, as of 20 January 2007, a new statutory liability regime for the periodic financial reports required by DTR 4 which we looked at above, through changes to the Financial Services and Markets Act 2000 (FSMA). These rules

applied for financial periods starting on or after 20 January 2007 and so for many companies, they had no impact until 2008.

Under new section 90A of the FSMA, introduced by section 1270 of the Act, an issuer is now liable to pay compensation to anyone acquiring securities and suffering loss as a result of any untrue or misleading statement in, or omission from any of:

- The annual report;
- The half yearly report;
- The interim management statement;
- Any preliminary statement published in advance of the annual report.

An issuer is liable in this regard, if a person 'discharging managerial responsibilities' for the publication:

- knew that the statement was wrong or misleading;
- was reckless as to whether it was; or
- knew any omission was a dishonest concealment of a material fact.

However, an issuer is only likely in practice to be liable where a director knew that the statement was wrong etc., because of the way '*persons discharging managerial responsibilities*' is defined. This definition includes any director of the issuer, any member where an issuer's affairs are managed by its members and any senior executive where an issuer does not have directors or members managing it (section 90A(9), FSMA).

There is also a 'safe harbour' provision, which protects directors from liability to third parties. Only the issuer will be liable to third parties (although the directors concerned could find themselves liable to the issuer, by virtue of section 90A(6), FSMA) .

The Act also introduced, under section 463, a new statutory liability regime for directors to the company for narrative reports. This makes directors liable to the company in respect of the entire directors' report, including:

- the new business review,
- the directors' remuneration report and

- the information in the summary financial statements ('SFS') that is taken from either of these reports.

Section 463(4) makes directors liable to the company only in respect of these reports. Section 463 came into effect on 20 January 2007, although it did not apply to a directors' report, directors' remuneration report or SFS first sent to members and others under section 238 or 251 of the Companies Act 1985 before 20 January 2007.

What has been the upshot of these changes? With an eye to deriving maximum benefit from the 'safe harbours' for directors, companies may have considered various steps – such as re-formatting their annual reports so as to move narrative commentary incorporated into (for example) the chairman's statement, so that it now appears in a single report covered by a safe harbour provision – for example, the management report for DTR purposes and the directors' report.

4.4 Interaction with the Takeovers Directive

The Directive on Takeover Bids (2004/25/EC) (the Takeovers Directive) was implemented in the UK on 20 May 2006 by the way of Takeovers Directive (Interim Implementation) Regulations 2006 (the Regulations). The Regulations were an interim measure, brought in so as to ensure the implementation of the Directive on 20 May 2006; they were revoked when Part 28 of the Act, as it relates to takeovers, came into force on 6 April 2007.

Between 20 May 2006 and 6 April 2007, a 'two track regime' operated for the regulation of takeover offers. That is, the Code Rules and the Takeover Panel operated:

- on a statutory basis for offers governed by the Takeovers Directive (i.e. offers for companies whose securities are admitted to a regulated market – including the London Stock Exchange but not AIM) and
- on a non-statutory basis for all other offers. When Part 28 of the Act came into force, this two-track regime fell away and the Panel's statutory powers were extended to the regulation of all takeover offers within its jurisdiction.

The criminal offence for failure to comply with the rules on the contents of offer documents/response documents still, however, only applies to offers to which the Takeovers Directive applies following the coming-into-force of Part 28 of the Act.

The compulsory acquisition procedures for a bidder to acquire outstanding minority shareholders, which were set out in:

- sections 428–430F of the Companies Act 1985 and,
- in relation to offers to which the Takeovers Directive applies, in schedule 2 of the Regulations,

were brought together in a unified 'compulsory acquisition procedure' set out in Part 28 of the Act. This meant that sections 428–430F of the Companies Act 1985 could be repealed, and this occurred on 6 April 2007.

In addition, a new 'long-stop' date of six months was brought in, during which the bidder can serve squeeze-out notices for non-Takeover Directive offers. There is still, therefore, a practical timing difference in the compulsory acquisition procedure under Part 28, depending on the nature of the offer.

4.5 Other miscellaneous changes which came into effect on 6 April 2007

In addition to Part 28 of the Act (takeovers), various other provisions came into force on 6 April 2007 – and consequently some other provisions of the Companies Act 1985 were also repealed on that date. They included:

- The Companies Acts (Unregistered Companies) Regulations 2007, which extended certain provisions of the Act regarding takeovers of unregistered companies, including the compulsory acquisition procedure where the unregistered target company has voting shares admitted to trading on a regulated market, came into force;
- Sections 293 and 294 of the Companies Act 1985, which prohibited people aged 70 or more from being directors of public companies or private company subsidiaries of public companies, were repealed;

- The provisions in Part X and Schedule 13 of the Companies Act 1985 relating to disclosure of share dealings by directors and their families were repealed. They were not directly replaced in the Act, as the Government apparently felt this would be to 'goldplate' EU Directive requirements for directors over and above those set out in the Market Abuse Directive (as implemented in the UK by the Disclosure and Transparency Rules);
- Section 311 of the Companies Act 1985, which prohibited tax-free payments to directors, was repealed.

4.6 Directors' duties

One of the Act's most significant (and controversial) parts – Part 10 – has been the codification of directors' duties. This introduced a statutory statement of directors' duties which has replaced many of the common law and equitable rules. Part 10 came into force on 1 October 2007, aside from the following:

- The provisions on directors' conflicts of interest (sections 175–177, 180(1), (2) and (4)(b), 181(2) and (3) and 182–187). These came into force on 1 October 2008;
- Particulars of directors to be registered and residential addresses (sections 162–167 and 240–246). These will come into force on 1 October 2009;
- The provisions on underage and natural directors (sections 155–159). These came into force on 1 October 2008;
- Section 247 (power to make provision for employees on cessation or transfer of business), which will come into force on 1 October 2009.

The new 'statement of duties' does not attempt to cover all duties that a director may owe to the company – others are also incorporated in the Act (e.g. the duty to deliver accounts) – and some, of course, remain uncodified (such as the duty to consider creditors' interests in times of threatened insolvency) but still have meaning.

Companies may choose to include more onerous duties in their articles. However, the articles may not dilute the duties except to the extent expressly allowed by the Act.

In addition, regard will have to be had for the common law rules and equitable principles that exist in interpreting and applying the general directors' duties under the Act.

The codified duties apply to all the directors of a company, including 'shadow directors' and, in the case of:

- the duties in section 175 (duty to avoid conflicts of interests) and
- 176 (duty not to accept benefits from third parties),

even former directors of the company. However, as shadow directors and former directors are not in the same position as actual directors, the application of the duties to shadow directors applies only to the extent that the corresponding common law rules or equitable principles so apply (section 170(5)). Application to former directors is 'subject to any necessary adaptations'.

The codified duties are still owed to the company, so only the company may enforce them. In certain circumstances, shareholders may be able to bring a 'derivative action' (see below), albeit that they will essentially be doing so on the company's behalf.

The statutory statement of duties comprises seven **general duties** (under sections 171–177 of the Act). They are:

- **Duty to act within powers**. A director must act in accordance with the company's constitution and must only exercise his powers for their proper purpose;
- **Duty to promote the success of the company for the members' benefit**. In fulfilling this duty, a director must have regard to certain prescribed factors, which we will look at shortly;
- **Duty to exercise independent judgment**;
- **Duty to exercise reasonable care, skill and diligence**. A director must exercise the care, skill and diligence which would be exercised by a reasonably diligent person with the general knowledge, skill and experience that may be reasonably expected of a person carrying out the functions carried out by the director in relation to the company **and** the actual general knowledge, skill and experience that the

director has. It may be noted that this provision has been based on the tests laid down in section 214 of the Insolvency Act 1986, incorporating as it does both an objective and a subjective element. In applying the test, regard will be paid to the functions of the particular director, including his specific responsibilities and the circumstances of the company;

- **Duty to avoid conflicts of interest**. We will look in more detail at this important area shortly;
- **Duty not to accept benefits from third parties**. This duty is not infringed if the acceptance of the benefit cannot reasonably be regarded as likely to give rise to a conflict of interest. Benefits conferred by the company, its holding company or subsidiaries and benefits given by the director's service contract are also excluded;
- **Duty to declare interest in proposed transaction or arrangement with the company.** Directors must declare to the other directors the nature and extent of any interest, direct or indirect, in a proposed transaction or arrangement with the company. The director need not be a party to the transaction for the duty to apply. A director need not make a declaration of interest if his interest cannot reasonably be regarded as likely to give rise to a conflict of interest (this replaces the materiality test in Regulation 85 of the old Table A model articles referred to earlier).

The most significant changes that were made under the Act in relation to directors' duties were undoubtedly:

- The statutory requirement for directors to have regard to a list of factors in exercising their duty to promote the success of the company for the members' benefit and
- Allowing independent directors to authorise a director's conflict of interest.

As we noted in Chapter 1, section 172 of the Act also introduced the so-called concept of 'enlightened shareholder value' into the duty to promote the success of the company for the members' benefit. This requires a director to 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.

In fulfilling this duty, a director must have regard (amongst other matters) to:

- The likely long-term consequences of any decision;
- The interests of the company's employees;
- The need to foster the company's business relationships with suppliers, customers and others;
- The impact of the company's operations on the community and the environment;
- The desirability of the company maintaining a reputation for high standards of business conduct;
- The need to act fairly as between the members of the company.

The list of factors which directors are required 'to have regard to' is not intended to be exhaustive. This duty is also subject to any enactment or rule of law requiring directors in certain circumstances to consider or act in the interests of the creditors of the company (for example, where the company is insolvent or threatened by insolvency).

This newly stated duty to 'promote the success of the company' could broadly be seen as replacing the old fiduciary duty to act in the company's best interests. However, the meaning of 'success for the benefit of the company's members as a whole' is perhaps less than entirely clear. The Government has stated that 'success' in this context will usually mean 'long-term increase in value' for commercial companies; it also says that the decision as to what will promote the success of the company, and what constitutes such success, is one for the director's good faith judgment – its view being that this ensures that business decisions on, for example, strategy and tactics are for the directors, and not subject to decision by the courts, subject always to good faith.

It is also worth considering further the duty to avoid conflicts of interest, which is set out under section 175 of the Act. This states that a director must avoid situations in which he has, or could have, a direct or indirect interest that conflicts (or could

conflict) with the interests of the company. This is particularly relevant where there could be some exploitation of information, property, or opportunity (and this is conceivably the case whether or not the company could itself be in a position to take advantage of the property, information or opportunity).

This particular duty does not apply to a conflict of interest which arises in relation to a transaction or arrangement with the company itself. These do not have to be authorised by either the members or the board – instead, directors must declare their interests in transactions or arrangements with the company under:

- section 177 of the Act, in the case of proposed transactions or
- section 182 in the case of existing transactions,

unless an exception applies under those sections.

The sections of the Act which deals with directors' conflicts of interest came into force on 1 October 2008. The duty to avoid conflicts of interest is not infringed where:

- a situation could not reasonably be seen as likely to give rise to a conflict or
- the matter is authorised by the directors.

Such directors' authorisation may be given in a private company where the constitution does not invalidate the authorisation (so this should of course be checked), or, for a public company, where the constitution specifically allows the directors to authorise the matter being proposed.

For companies incorporated before 1 October 2008, transitional arrangements are made in the Companies Act 2006 (Commencement No. 5, Transitional Provisions and Savings) Order 2007. These permit directors of such companies to authorise conflicts, *provided* their shareholders pass a resolution (before, on or after 1 October 2008) permitting this to happen.

It should be noted that the board's authorisation is only effective provided the required quorum is met without counting the director in question – or indeed any other

interested director. In allowing independent directors to authorise a director's conflict of interest, section 175 of the Act introduced a change to the requirement for shareholder approval that existed under earlier law (with a caveat for the transitional arrangements for companies incorporated before 1 October 2008, where shareholder authorisation is required before the independent board may authorise conflicts).

Most companies are likely to have reviewed and – in many cases – amended their articles of association to include a general power for directors to authorise conflicts. Some will also have included provisions in their articles for the management of conflict situations. Section 180(4)(b) of the Act provides a safe harbour for directors to take advantage of all available protections; provided the directors act in accordance with provisions in the company's articles for dealing with conflicts, they will not be in breach of their general duties under the Act.

Under section 176 of the Act, board authorisation is not specifically allowed in respect of acceptance of benefits from third parties; a director obtaining a benefit from a third party can only be authorised to do so by the members of the company, unless the articles include provisions for dealing with conflicts of interest that are not infringed by the directors accepting a benefit from a third party in accordance with the provisions of the articles – this is dealt in section 180(4)(b), which came into force on 1 October 2008.

So there are clearly a large number of changes to the regime for directors' duties under the new Act – some of them sweeping, some – on the face of it at least – more subtle. The question is, have these newly-codified duties (and the list of factors that a director must 'have regard to') result in more bureaucracy at board level?

This is a legitimate concern: since section 172 of the Act, with its concept of 'enlightened shareholder value', sets out an (apparently) mandatory list of factors which directors must consider, one would expect greater bureaucracy at board level – with, for example, more detailed board minutes – as well as exposing directors to the prospect of greater potential liabilities.

Some commentators have argued however that directors were not previously, and should not be now, as a result of the legislative codification, forced to evidence their thought processes – whether with regard to the stated factors (to 'have regard to') or to any other matter influencing their thinking. Apart from the unnecessary process and paperwork this would introduce into the boardroom, this could only serve to increase the risk of litigation against directors, especially in light of the new derivative action also being brought in by the Act (see below).

A pragmatic solution appears to be as follows:

- Companies should ensure that their directors are fully aware of their duties under the Act. As well as providing all existing, and any new, directors with training on their duties under the Act, their terms of appointment and any role descriptions could usefully be amended to make reference to these duties;
- Companies should review their policies in areas such as human resources, ethics, compliance and corporate responsibility against the background of the new duties;
- Where decisions are taken by formal board process, a formal board paper will usually be prepared. It would be sensible for the member of the management team responsible for preparing the paper to ensure that each relevant factor, (including those specifically referred to in the Act) are properly considered whilst the paper is being prepared. This might involve making explicit reference to some or all of them in the paper. It would probably be going too far (and indeed perhaps set a dangerous precedent) to require that a negative statement in relation to each of the factors be drafted in, since failure to do so in subsequent papers could be taken as an indication that no regard was given to that factor;
- It is unlikely that board minutes should be the only, or even the main, medium for recording the extent to which each factor was discussed – they have not, after all, usually done so previously insofar as either common law or statutory duties required directors to consider particular factors. The minimum requirement for minutes should only be that they clearly state the decision reached.

4.7 Directors – appointment and other matters

The provisions relating to directors' service contracts and directors' loans contained in Part 10 of the Act came into force on 1 October 2007.

In respect of directors' service contracts, the requirement which existed under section 319 of the Companies Act 1985 for shareholder approval of contracts in excess of five years has been amended. Now, under section 188 of the new Act, shareholder approval is required for directors' service contracts in excess of two years.

A number of changes have also been made in respect of loans to directors; these include:

- The abolition of the prohibition on loans, quasi-loans and the like to directors – this having been replaced with a requirement for shareholder approval;
- The rules on credit transactions and quasi-loans do not apply to private companies unless they are associated with a public company. A public company or company associated with a public company can, again, make a quasi-loan to a director with shareholder approval;
- The Act does not apply the rules on loans, quasi-loans and credit transactions with persons connected to a director to private companies, unless those private companies are associated with a public company;
- An increase in the maximum amounts for those exceptions from the requirement for shareholder approval, for expenditure on company business, small loans, small quasi-loans and small credit transactions.

The Act also included changes to the protocols for directors' appointment. These included:

- A requirement that companies should have at least one director who is a natural person from 1 October 2008 (there was a grace period for existing companies which did not have a natural person as a director on 8 November 2006 – the date at which the Act received royal assent. These companies have until October 2010 to appoint at least one natural person as a director;

- A minimum age of 16 years for directors of all companies from 1 October 2008;
- The ability to use a director's service address rather than his residential address on the company's register of directors. These provisions will come into force on 1 October 2009;
- The repeal of the 70-year age limit for directors of public companies and private companies which are subsidiaries of public companies. This took effect on 6 April 2007.

Provisions relating to substantial property transactions and directors' liabilities, which are set out in Part 10 of the Act, came into force on 1 October 2007.

The main changes that have been made to the law as it stood under the Companies Act 1985 on substantial property transactions with directors, entered into on or after 1 October 2007, are:

- The ability to make an agreement conditional on shareholder approval being received for the transaction;
- The ability to make an agreement for a substantial property transaction conditional on approval from the members of the company's holding company, where their approval is needed;
- The raising of the *de minimis* threshold for the requisite value of non-cash assets to £5000

In terms of directors' liabilities and indemnities, the law as it stood under the Companies Act 1985 has largely been restated in the new Act. There is, however, a new provision allowing companies to provide Qualifying Pension Scheme Indemnity Provisions. What this means is that pension trustee companies (and their associated companies) can indemnify a director of that pension trustee company against certain liabilities which might be incurred in connection with the company's activities as trustee of the scheme.

The Act also put on a statutory footing the shareholders' ability to ratify, by ordinary resolution (unless anything in the company's articles requires a higher majority or unanimity), a director's conduct on or after 1 October 2007 where that conduct amounts to:

- Negligence;
- Default;
- Brach of duty; or
- breach of trust in relation to the company.

This is, however, subject to a requirement that the votes in favour of the resolution cast by the director (if he is also a shareholder) and the votes of any member connected with him are disregarded in determining whether the resolution is passed.

4.8 Derivative claims

Part 11 of the Act on derivative claims came into force on 1 October 2007. However, where a claimant had applied for permission to continue a derivative claim before 1 October 2007, the law in force before that date applies.

Section 260 of the new Act defines a 'derivative claim' and this is made up of three parts:

- it must be brought by a member of the company;
- the cause of action must be vested in the company; and
- the relief must be being sought on behalf of the company (as opposed to on behalf of the member).

A key change brought in under the new Act was the prescription of a wider range of circumstances in which a derivative action can be brought by a shareholder than was the case under common law. For example:

- An actual or proposed act or omission involving negligence, default, breach of duty or breach of trust by a director of the company may now give rise to a cause of action;
- A derivative action is available for breach of duty of directors, even if the director has not benefited personally from the breach;
- It is no longer necessary for the members to show that those directors who carried out the wrongdoing control the majority of the company's shares;

- There is now a two-stage procedure for an applicant seeking permission to continue a derivative claim:
  - First, the member must make a prima facie case for permission to continue a derivative claim. The court must consider the issue on the basis of evidence filed by him, without requiring evidence from the defendant. It must dismiss the application if the applicant cannot establish a prima facie case.
  - Secondly, the court may require evidence to be provided by the company (prior to the start of the substantive action).
- If a derivative claim arises from acts or omissions which occurred before 1 October 2007, the court can only exercise its powers under sections 260–264 of the new Act to hear it if (or to the extent that) it would have been allowed to proceed as a derivative claim under the law in force before 1 October 2007.

There has been some concern that the changes to the derivative action regime could lead to more 'tactical litigation' against directors from so-called activist shareholders. This was particularly worrying in the context of the changes in law relating to directors' duties in Part 10 of the Act. So far, these concerns seem to have been unfounded, as there have been few reported cases of a derivative claim having been brought under the 2006 Act – but it is not impossible that in the current straitened economic environment (February 2009) these could increase. Boards may wish to review their D&O liability insurance policies to ensure that defence of derivative claims is covered by them. In addition, of course, the costs of such policies may rise, at least unless and until it becomes clear how derivative claims under the Act will be dealt with by the courts.

4.9 Business Review

Section 417 of the Act came into force on 1 October 2007, and deals with directors' reports for financial years beginning on or after 1 October 2007. It sets out what must be included in the business review element of the directors' report on the accounts. In the same way as was the case under the

Companies Act 1985, all companies other than 'small companies' must produce a business review.

The new Act introduced a requirement that quoted companies include specific information in their business review on '*the main trends and factors likely to affect the future development, performance and position of the company's business*' – as well as information about:

- Environmental matters;
- The company's employees;
- Social and community issues;
- Persons with whom the company has contractual or other arrangements essential to the business.

Quoted companies therefore now have a forward-looking element to their business reviews. The business reviews of unquoted companies are likely only to look back over the past year.

Where directors of quoted companies have nothing to report on environmental, employee or social and community matters, or persons with whom the company has contractual arrangements, their review must state that this is the case.

The board can, in preparing the business review, leave out information about impending developments or matters in the course of negotiation where, in their opinion, disclosure would be seriously prejudicial to the interests of the company.

There is also a carve-out in relation to the disclosure of persons with whom the company has contractual or other arrangements essential to the business. Disclosure is not required if '*the disclosure would, in the opinion of the directors, be seriously prejudicial to that person and contrary to the public interest.*' This is mainly aimed at preventing the misuse of such information by – for example – animal rights extremists.

The requirement to disclose 'persons with whom the company has contractual or other arrangements' was initially met with some concern that it would increase costs for quoted companies, and might be interpreted as a requirement to disclose a full list of all supplier and customer contracts. Fortunately, some clarification was gained during the final debates on the

Companies Bill, where Lord Sainsbury stated that the new provisions would not create an obligation for companies to list their suppliers and customers, or to provide details about contracts. He advised that the aim was to bring about reporting on 'significant' relationships, such as major suppliers or key customers critical to the business, likely to influence (directly or indirectly) the performance of the business and its value.

Directors must, of course, exercise their judgment on what to report. For example, if a company relies on a single supplier for a key component, to the extent that if the supplier went bust there would be a serious impact on the company's business, then this should clearly be disclosed.

Section 393 of the new Act reinforces the 'true and fair view' requirement that existed before, by imposing a specific obligation on the directors not to approve the accounts unless they are satisfied that they give a true and fair view of the assets, liabilities, financial position and profit or loss of the company. This provision came into force on 6 April 2008.

4.10 Liability limitation agreements – auditors

Under chapter 6 of Part 16 of the new Act, auditors and companies can enter into 'liability limitation agreements' to limit the auditor's liability to the company for negligence, default, or breach of duty or trust in relation to the audit of the accounts.

These provisions came into force on 6 April 2008. Such an agreement cannot limit the auditor's liability to less than an amount that is fair and reasonable in all the circumstances of the case having regard to:

- The auditor's responsibilities;
- The nature and purpose of the auditor's contractual obligations to the company;
- The professional standards expected of him;
- The limit on the amount of the auditor's liability does not need to be a sum of money, or a formula, specified in the agreement.

Liability limitation agreements must be approved by ordinary resolution, unless any higher threshold for approval is set in the company's articles (note that private companies may resolve to waive the need for approval).

Shareholders in either a private or a public company can pass a resolution approving the principal terms of a liability limitation agreement, either before or after it is signed. A company may, by ordinary resolution, withdraw its authorisation for a liability limitation agreement despite anything to the contrary in the agreement itself.

A liability limitation agreement must not apply in respect of acts or omissions occurring in the course of the audit of accounts for more than one financial year, and must specify the financial year to which it applies.

Companies are required to disclose any liability limitation agreement they have made with their auditor. The Secretary of State has made regulations on the provisions which must or must not be included in such an agreement, and to require disclosure of them in a company's accounts (see The Companies (Disclosure of Auditor Remuneration and Liability Limitation Agreements) Regulations 2008, which specify the content and method of disclosure of liability limitation agreements).

Companies must disclose, by means of a note to their annual accounts, the principal terms of the agreement, and the date of the resolution approving it or waiving the need for approval.

The Financial Reporting Council has issued draft guidance on auditor liability limitation agreements, together with a consultation paper on the guidance. The guidance includes specimen wording for inclusion in shareholder resolutions and specimen principal terms and clauses for a liability limitation agreement.

4.11 Other matters relating to auditors

Section 507 of the new Act created a new criminal offence, punishable by fine, in relation to inaccurate auditors' reports.

That is, a person commits an offence if he knowingly or recklessly causes an auditor's report to include any matter that is misleading, false or deceptive in a material particular or if he omits a statement required by section 498(2) (b), (3) or (5) of the Act (which is to say statements relating to problems with the accounts).

The offence can be committed by an individual auditor (or his employee or agent) or, where the auditor is a firm, a director, member, employee or agent of the audit firm. The Government has said that it will produce guidance on the new offence, so as to limit the possible adverse consequences when an auditor's behaviour might give rise to both disciplinary actions by professional supervisory bodies, and to prosecution for an offence under section 507 of the Act. The Act also provides that, where the auditor is a firm, a 'senior statutory auditor' must sign the report in his own name on behalf of the firm. The 'senior statutory auditor' is defined as the person identified by the firm in accordance with European Commission standards or, if there is no applicable standard issued, any relevant guidance issued by the Secretary of State.

The name of the auditor (and senior statutory auditor where applicable) must be stated on every copy of the auditor's report that is published. There is an exemption from the requirement to include the name of the auditor and this is when the company resolves not to reveal the names as it considers to do so would lead to a serious risk of violence or intimidation. These changes came into force on 6 April 2008.

4.12 Deregulation

As part of the 'think small first' ethos which runs throughout the Act, certain requirements under the 1985 Act have been, or will be, abolished (and in certain cases, the abolition extends to public companies). Key changes include:

- **AGMs:** Private companies are no longer required to hold an AGM from 1 October 2007, although they may still opt to do so. The repeal of this requirement does not affect any provision of a private company's memorandum or articles

that expressly requires the company to hold an AGM, although a private company does not have to hold an AGM even if its articles expressly state that they must be held, provided an elective resolution under section 366A of the Companies Act 1985 – dispensing with the need to hold AGMs – was in force immediately prior to 1 October 2007. A provision specifying that one or more directors are to retire at an AGM does not count as a provision expressly requiring the company to hold an AGM.

- **Accounts at AGMs:** Also, private companies are no longer obliged to lay accounts and reports before general meetings. Therefore, for private companies, there is no statutory link between the accounts and annual general meetings, although the articles may create such a link.
- **Need for company secretary:** Private companies need no longer have a secretary from 6 April 2008, although they may choose to retain one. If a private company decides to have (or keep, in the case of existing companies) a secretary, the secretary will still have statutory powers and must be registered at Companies House. A private company whose articles immediately before 6 April 2008 expressly required it to have a secretary is a company 'with a secretary' for the purposes of section 270(2) of the new Act, unless and until its articles are amended to remove the requirement. Any provision requiring or authorising things to be done by or in relation to a secretary, or as to the manner in which, or terms on which, a secretary is to be appointed or removed, is not a provision expressly requiring the company to have a secretary.
- **Financial assistance:** The prohibition on a private company giving financial assistance for the purchase of its shares, together with the 'whitewash' procedure, were repealed on 1 October 2008.
- **Authority to allot:** A private company with only one class of shares will not need to obtain authority to allot shares unless its articles specifically require it, and such shares may be allotted without complying with the statutory pre-emption requirements where this is authorised by a special resolution or by a power in the company's articles. These provisions will take effect on 1 October 2009.

- **Shareholders' addresses:** Only public companies with shares traded on EU regulated markets ('traded companies') will need to include their shareholders' addresses in their annual return – and then only in respect of those shareholders who held 5% or more of any class of shares during the year in question (see The Companies Act 2006 (Annual Return and Service Addresses) Regulations 2008 (SI 2008/3000)). This change will take effect on 1 October 2009. However, interim provisions were introduced on 1 October 2008 by way of amendments to the 1985 Act that reflect the provisions of The Companies Act 2006 (Annual Return and Service Addresses) Regulations 2008 (SI 2008/3000), which only require traded companies to include shareholders' addresses in the annual return and then only in respect of shareholders holding more than 5%.
- **Authorised share capital:** The Act abolishes the requirement for companies (both private and public) to have an authorised share capital with effect from 1 October 2009. Shareholders wishing to restrict the number of shares that can be issued by a company will therefore need to amend the articles to include suitable provisions, if the articles do not already contain such restrictions.
- **Objects:** The Act abolishes the objects clauses in the memorandum and a company's objects will be unrestricted unless any specific restrictions are set out in the company's articles (section 31). This applies to both new and existing companies with effect from 1 October 2009. Existing companies need not change their objects, since section 28 of the Act treats the existing objects clauses in the memorandum as provisions of the articles. Any existing company that wishes to amend its objects to make them unrestricted going forward can do so by amending its articles and removing the restrictions on its objects.
- **Memorandum of association:** This will only contain details of the initial subscribers for shares, and it will no longer be possible to amend or update a memorandum. The memorandum will essentially be a 'snapshot' of part of the company's constitution at the point of registration and will have no continuing relevance. The memorandum of a company

formed under the Act will therefore look very different from that of a company registered under the Companies Act 1985 (see The Companies (Registration) Regulations 2008 (SI 2008/3014) for the form of a memorandum under the Act). For existing companies, provisions that were in the memorandum will not be deleted by the Act but will be treated as provisions in the articles of association. The provisions relating to memoranda, including The Companies (Registration) Regulations 2008, will come into force on 1 October 2009.

- **Directors' addresses:** There is a change to the existing law in relation to the particulars to be entered on the register of directors. Companies should provide a service address rather than the director's usual residential address. A director may give the company's registered office as his or her service address; the service address may also be the same as the director's residential address – but this will not be apparent from the public record. The Secretary of State has power under the Act to make regulations requiring the Registrar, on application, to make an address on the register unavailable for public inspection (see draft of The Companies (Disclosure of Address) Regulations 2008). Addresses filed before 1 January 2003 are excluded from such regulations as such information is held on microfiche and is therefore difficult to remove. The grounds for making an application to make an address unavailable for public inspection are that there is a serious risk that the director or someone living with him will be subjected to violence or intimidation as a result of the activities of the company – as has occasionally happened to directors of companies attracting the attentions of animal rights activists. It may also of course help reduce the risk of identity theft. These provisions relating to directors' residential addresses will come into force on 1 October 2009.

4.13 Share capital

There will no longer be a requirement for companies to have an authorised share capital, and private companies with only one

class of shares will not need to obtain authority to allot shares (see above).

There is a new requirement under the Act for companies making any change to their share capital to file a statement of capital with the Registrar of Companies, containing certain prescribed particulars in relation to the shares.

Other key changes in relation to a company's share capital include the following (all take effect from 1 October 2009, apart from the new solvency statement procedure for a reduction of capital by a private company, which came into effect on 1 October 2008):

- **Reduction of capital**. There is a new solvency statement procedure for private companies, as an alternative to the court-approved procedure for a share capital reduction (which remains in place). A company using the new solvency statement procedure will not be able to reduce its share capital to zero. A specific authorisation in a company's articles to reduce its share capital will no longer be required. A company will not be able to reduce its capital, however, if it is prevented from doing so by the articles (section 641(6), the Act).
- **Re-denomination of capital**. The Act introduces a simplified procedure for re-denominating share capital, which allows a company limited by shares to re-denominate its share capital by ordinary resolution. It also introduces a procedure allowing the company to cancel part of its share capital after conversion in order to re-nominalise its shares (this allows the company to round share values to a sensible value) without obtaining the prior approval of the courts.
- **Share premium**. The Act reduces the purposes for which the share premium account can be used. In future, companies will neither be permitted to use the share premium account to write off expenses incurred in connection with the company's formation, nor will they be permitted to use the share premium account to write off any expenses incurred, commission paid, or discount allowed in respect of an issue of debentures, or in providing for the premium payable on a redemption of debentures.

- **Redeemable shares**. Under the Act, a private company will no longer need to be authorised by its articles to allot redeemable shares, although it may exclude or restrict the issue of redeemable shares by making an appropriate amendment to its articles. A public company wishing to allot redeemable shares will still need to be authorised to do so by its articles.

4.14 Financial assistance

The repeal of the restrictions under the Companies Act 1985 on financial assistance for the acquisition of shares in a private company, including the 'whitewash' procedure, took effect on 1 October 2008. The prohibition on the giving of financial assistance by a public company or a public company subsidiary for the purpose of an acquisition of shares in its private holding company is retained under the Act as is the prohibition on the giving of post-acquisition assistance by a public company subsidiary. Chapter 2 of Part 18 (financial assistance) of the Act will come into force on 1 October 2009.

At an early stage, there was some concern that despite the abolition of the financial assistance prohibition on private companies, common law rules on maintenance of capital (e.g. see *Trevor v Whitworth* [1887] 12 App Cas 409) could still operate in certain circumstances to prevent a private company from giving financial assistance for the purchase of its shares. To address this concern, the Government clarified in a saving provision in paragraph 52 of Schedule 4 to the Fifth Commencement Order that common law does not have the effect of reinstating sections 151–153 of the Companies Act 1985 – nor does it override other legal considerations relating to the giving of financial assistance.

4.15 AGMs – quoted companies

Under the new Act, a public company must hold its AGM within six months of the end of the relevant accounting reference period (section 336). Although this section came into

force on 1 October 2007, transitional amendments were made so that the six month period only applies from the end of the first accounting reference period after 6 April 2008 in respect of which the company draws up its accounts under the provisions of the 2006 Act.

New obligations have been imposed on quoted companies relating to their making information available on a website. From 6 April 2008, quoted companies are required to make available on their website their annual accounts and reports until annual accounts and reports for the next financial year are made available on the website.

Members of a public company holding at least 5% of the voting rights or at least 100 members of a public company holding on average £100 paid-up capital, have the right to propose a resolution for the AGM agenda and to require the company to circulate details of the resolution to all members. The shares relied on to trigger the notice of the resolution must carry rights to vote on the relevant resolution, and where the members' request is received before the company's financial year-end, then the members are not required to cover the costs of circulation of the resolution. These provisions came into force on 1 October 2007.

The Act has given new rights to members of quoted companies to raise audit concerns at accounts meetings in relation to accounts for financial years beginning on or after 6 April 2008. The members of a quoted company (large enough in number or with a sufficient percentage shareholding) may require the company to publish on a website a statement setting out any matter relating to the audit of the company's accounts that are to be laid before the next accounts meeting, or any circumstances connected with a departing auditor of the company since the previous accounts meeting, that the members propose to raise at the next accounts meeting of the company. The statement must be made available within three working days of the company being required to publish it on a website and it must be kept available until after the meeting to which it relates.

Quoted companies are subject to new requirements where a poll is taken at a general meeting of which notice is given on

or after 1 October 2007; quoted companies are required to disclose on a website the results of polls taken at general meetings, and to obtain and disclose on a website an independent report on a poll if a sufficient number of members demand one. The information must be made available as soon as reasonably practicable and must be kept available for a period of two years.

The new Act heralded a sea-change in company law and the role and duties of directors, with new potential for claims against them. It is important that directors are mindful of this in a world where shareholder activism is on the rise.

4.16 Summary

The new Act has clearly introduced sweeping changes to company governance, and as yet neither all the implications are entirely clear – nor will they be until case law has indicated how the courts will interpret the new provisions in practice. The Act was supplemented by a set of Explanatory Notes, produced by the then DTI to 'assist the reader in understanding the Act'. These explanatory notes are not binding, but provide useful 'handrails' to aid orientation in the new legislation, and give an insight into how government would anticipate the provisions being interpreted.

Internal Controls and Risk Management

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5.1 Background

In this chapter, we will consider the various internal controls that contribute to the governance framework of a company.

The aim of a company's system of internal controls should be to ensure that its management systems, accounting records, asset maintenance and compliance issues are operating correctly. Internal controls ensure both the effectiveness of a company's operations and the reliability of its internal and external reporting. They also assist in its compliance with laws and regulations. The Combined Code (the Code), which we looked at in Chapter 2, includes several recommendations for listed companies in relation to internal control, and the Turnbull (which we also came across in Chapter 2) guidance helps boards to implement those recommendations.

Section 1 of the Code places several obligations on directors with regard to internal controls:

- The board should maintain a sound system of internal control to safeguard shareholders' investment and the company's assets (*Main Principle C.2*);
- The board should, at least annually, conduct a review of the effectiveness of the group's system of internal control and report to shareholders that they have done so. The review should cover all material controls, including financial, operational and compliance controls and risk management systems (*Code Provision C.2.1*).

Code Provision C.2.1 does not require a report on effectiveness, but rather a report **that a review of effectiveness has been conducted**, although many companies go beyond this minimum requirement. In addition, Code Provision C.2.1 makes it clear that all types of internal control not simply 'financial' are to be taken into account. In the 1998 version of the Code, this change was considered to be of such effect that the equivalent C.2.1 requirement was suspended until guidance was issued on its application (the Turnbull guidance, which we will look at below).

The UK Listing Authority's Listing Rules require a UK-incorporated listed company to state in its annual report and accounts how it has applied the Main Principles set out in section 1 of the Code and whether or not it has complied with the Code's provisions (*LR 9.8.6R(5) and 9.8.6R(6)*); this is the so-called 'comply or explain approach'. Its auditors must review the statement insofar as it relates to certain matters, including internal control (*LR 9.8.10R(2)*).

5.2 The Turnbull Report

In September 1999, the Institute of Chartered Accountants of England and Wales (ICAEW) published guidance on internal controls – the Turnbull Report. This guidance provided assistance to directors of listed companies on implementing the internal control recommendations set out in the Code and to help them ensure that they have in place effective risk management and internal control systems for the management of risks that are significant to the fulfilment of their business objectives.

The Report's philosophy is that, while many risks cannot be eliminated or transferred, (although some can), a proper and achievable aim of a company is to manage risk while still remaining competitive in the external business environment. It seeks to address the concern that strictly regulated internal control procedures may stifle entrepreneurial activity by recognising that every company has its own set of objectives and operates in its own unique environment, each of which may be subject to more or less continual change.

The Report aimed to allow a company to tailor its procedures according to its own particular circumstances.

In July 2004, the Financial Reporting Council (FRC) set up a group to review and update the guidance where necessary, in the light of experience in implementing the guidance and developments in the UK and internationally since 1999. On 16 June 2005, the FRC published for consultation its proposals for updating the Turnbull guidance, in which it proposed only limited changes to the guidance. It considered that the

guidance should continue to cover all internal controls and that no changes should be made that would restrict a company's ability to apply the guidance in a manner suitable to its own circumstances.

In October 2005, the FRC published an updated version of the Turnbull guidance. The main changes in the updated version were as follows:

- Company boards are encouraged to review their application of the Turnbull guidance on a continuing basis. They should also inform shareholders how they manage risk and internal control in the internal control statement;
- The message that the Turnbull guidance is intended to reflect sound business practice as well as help companies comply with the internal control requirements of the Code is reinforced;
- References to the Code and Listing Rules have been updated;
- Directors will be expected to apply the same standard of care when reviewing the effectiveness of internal control as when exercising their general duties;
- The section of the Turnbull guidance relating to the Code provisions on internal audit has been moved to the FRC guidance on audit committees (formerly known as the Smith guidance);
- Boards must confirm in the company's annual report that any significant failings or weaknesses identified from their review of the effectiveness of the internal control system are being remedied. They must also include information to help shareholders' understanding of the main features of the company's risk management processes and system of internal control.

5.3 The Board's Responsibility

The Turnbull guidance emphasises that a company's system of internal control and the required statement to shareholders are the board's responsibility (*paragraph 15*).

It is the role of the board to set and implement appropriate policies on internal control and to ensure the system's effectiveness in managing key risks (*paragraph 17*). In this, Turnbull reflects wider company law.

The guidance acknowledges that, in practice, the board may delegate the task of implementing the board's policy on risk and control to management (*paragraph 25*). However, the board should be satisfied that those responsible for internal control collectively have the necessary skills and knowledge of the company, its business and its markets in order to perform this function. For example, it may be that the audit committee is unlikely to be an appropriate committee to which a board might delegate matters which extend beyond the purely financial.

If a company forms part of a group structure, any internal control procedures and reviews should be implemented with the group in mind (*paragraph 13*).

5.4 The risks that should be considered

All types of risk should be considered including operational, business, compliance and financial risks. Paragraph 16 of the Turnbull guidance provides that the board should assess:

- The extent and categories of risk which it regards as acceptable for the company to bear. (No specific guidance is offered as to how or why a board might identify a risk as 'unacceptable', or as to how to eliminate or reduce the company's exposure to such a risk. That this is the board's responsibility is however certain and the onus is also on the board to ensure that its decision as to which risks are indeed unacceptable is conveyed to, and shared by, management and others within the company);
- The likelihood of the risks materialising;
- The company's ability to reduce the impact on its business should the risks materialise;
- The costs contrasted with the benefits of relevant control procedures.

The guidance acknowledges the limitations of control systems. Even the most comprehensive system will not fully protect against, for example, human fallibility or unforeseeable events. However, a sound system will provide reasonable assurance against a failure to meet business objectives and against material errors, losses and fraud (*paragraphs 22 and 23*).

5.5 Effectiveness of internal control system

The Turnbull guidance states that a control system should be:

- Embedded in the operations of the company and form part of its culture;
- Capable of responding quickly to changing risks and to a changing business environment;
- Inclusive of procedures for identifying any significant control failings or weaknesses and reporting these to management immediately (*paragraph 21*).

The Appendix to the Turnbull guidance includes a series of questions to which a board of directors should have regard when setting up a system of internal control and reviewing its effectiveness.

5.6 Reviewing the effectiveness of internal controls

The board should take steps to ensure that the system is functioning effectively. It should regularly receive and review reports on internal control prepared during the year by management. This is in addition to an annual assessment in preparation for the required statement in the accounts (*paragraph 26*).

The reports by management should enable the board to:

- Focus on the significant risks and assess how they have been identified, evaluated and managed;
- Assess the system's effectiveness, having particular regard to the impact of weaknesses that have been reported;

- Consider whether necessary actions are being taken promptly and whether more extensive monitoring is needed (*paragraph 29*).

The board is required to undertake a specific annual assessment for the purpose of its statement in the accounts. This assessment should cover not only the accounting period, but the period up to the date of approval of the annual report and accounts also (*paragraph 30*). This over-arching review should cover:

- Any changes since the last annual assessment in the nature and extent of significant risks faced by the company;
- The company's ability to respond to change in its business and the external environment;
- The scope and quality of management's ongoing monitoring of the system;
- The extent and frequency of the communication to the board of information gathered in the course of monitoring the system;
- Any significant control weaknesses that have occurred and the extent to which they have or may have materially affected the company's financial performance or condition;
- The effectiveness of the company's public reporting processes (*paragraph 31*).

5.7 Statement in the accounts

Turnbull interprets the requirement that directors' report to shareholders that they have conducted a review of the effectiveness of their group's system of internal control, specifying for example, that the board's statement should provide users of the accounts with meaningful, high-level information and not be misleading (*paragraph 33*). The disclosure under Code Principle C.2 should, as a minimum, explain:

- That there is an ongoing process in place which identifies, evaluates and manages the significant risks;
- That it has been in place for the year under review and up to the date of approval of the accounts;
- That it is regularly reviewed by the board;
- That it accords with the Turnbull guidance (*paragraph 34*).

There should, in addition, be an express acknowledgement by the board that it is ultimately responsible for the system and for the review of its effectiveness. However, the board should also state that the system can only provide reasonable and not absolute assurance against misstatement or loss (*paragraph 35*).

In relation to the annual review of the system of internal control for Code Provision C.2.1, the board should summarise the review process and disclose how it has dealt with the material internal control aspects of any significant problems disclosed in the accounts (*paragraph 36*). It is not intended that the effectiveness of every internal control should be reviewed, but the review should extend to all types of controls, including those of an operational and compliance nature, as well as internal financial controls. Where the board is unable to make such disclosures, the board should state this fact and explain what it is doing to rectify the situation.

If material joint ventures and associates are not dealt with as part of the group for the purposes of applying Turnbull, this should be stated (*paragraph 38*).

The drafting of this statement should be high on the agenda since there is no prescribed form or content for it. For example, consideration should be given as to the line the company's auditors likely to take in relation to their review of the statement (and what the fee might implications be).

5.8 Practical steps to implement Turnbull

5.8.1 Anticipate future sources of risk in your business

Code Provision C.2.1 refers to the review as covering 'all material controls', including financial, operational and compliance controls and risk management systems. Of the many techniques available for assessing risk, some are detail-based and offer quantification while others are scenario-based or qualitative. A common starting point is to distinguish between internal risk (weaknesses contrasted with strengths) and external risk (threats contrasted with opportunities).

For example, heightened exposure to internal risk can often be traced to periods of rapid growth (whether organically or by acquisition); a culture which rewards excessive risk-taking; and inadequate systems for managing information. External risk may be harder to predict. Processes should be in place which monitor how these risks change over time. They may for example, include performance reports and indicators of change, or qualitative information such as on customer satisfaction, employee attitudes and the like. Other relevant questions include:

- How have product or service lines changed?
- Has the group entered into new markets?
- How is the regulatory environment changing?

5.8.2 Prioritise the key risks

The Turnbull guidance indicates that the focus should be on the significant risks facing a company. They might, for example, be centred in litigation, document management or intellectual property. Others will find that ethics, commodity trading or the concentration of powers in a general manager are the problem areas.

Those risks which are particularly likely to materialise and those which, if they did, would be particularly damaging should be highlighted. Connected risks should be grouped together, since the likelihood and/or seriousness of one risk may be affected by others. Those risks which are acceptable for the company to bear within its particular business, and those which are not, should be considered next. It may be helpful for the company to conduct benchmarking exercises in relation to specific areas in order to assess the company's relative risk profile.

5.8.3 Implement appropriate procedures

The premise of the Turnbull guidance is that risk can only be managed effectively within a corporate framework or infrastructure. What form would appropriate procedures take in relation to your group's business and how would they be embedded?

In the absence of an internal audit function, a smaller company may want to consider:

- Organising a workshop to revitalise its risk management effort;
- Preparing a policy document to be sent to all employees;
- Improving management reporting;
- Affording the topic of internal control a permanent place on the agenda at board and periodic management meetings;
- Formalising who exactly is responsible for key areas of risk;
- Inviting individuals in charge of key departments to attend at board/management meetings and take questions;
- Involving external auditors or other consultants on specific initiatives.

The emphasis at all times must be on making sure that Turnbull compliance is not seen as a one-off initiative. Do these procedures already exist or do current arrangements perhaps leave something to be desired? It may be that procedures related to financial controls are initially more compliant with Turnbull than those that relate to business, operational, compliance and other risks.

A good first step may be to analyse the recent past – did the company's existing control system pick up the more significant problems promptly enough?

It is also helpful to keep in mind:

- The characteristics of a sound system of control alluded to in the Appendix to the Turnbull guidance and described earlier;
- That the guidance may be tailored to individual circumstances;
- That, in judging a system, the costs of operating relevant controls relative to the benefit thereby obtained in managing the related risks should be assessed. Factors might include the size of the business; the diversity of operations; the degree of centralisation of financial and operations management; and the amount of contact between top management and day-to-day operations.

Finally, the key question that the Board should be asking itself is whether the company's control system passes

'the Turnbull test' – in other words, does it provide ''reasonable...assurance that [the] company will not be hindered in achieving its business objectives, or in the orderly and legitimate conduct of its business, by circumstances which may reasonably be foreseen?'' (*paragraph 23*).

5.9 Monitor ongoing performance

Performance against the Turnbull guidance should be assessed in the following key areas:

- If the board delegates responsibility for the system of internal control, there should be appropriate processes in place for the board to monitor the situation and form its own view. These might include self-assessment, confirmation by personnel of compliance with policies and codes of conduct and internal audit reviews. Those responsible should collectively possess the necessary skills, technical knowledge, information and authority. Any weaknesses should be strengthened, for example, by training programmes or restructuring;
- The board should regularly receive and review reports on progress against business objectives and related risks from management and/or others qualified to prepare them;
- The control system should include procedures for communicating to the board any significant weaknesses that are identified;
- If the company does not have an internal audit function, it should from time to time review the need for one. If it does have such a function, the board should annually review its scope of work, authority and resources.

5.10 Keeping a record

Managers charged with implementing the Turnbull guidance will have multiple objectives:

- to achieve compliance;
- to do so within normal management and governance processes;

- to build on the guidance so as to manage risk more effectively; and
- to take into account the recent trends in company law.

In relation to an important business decision (notably, just where to set the parameters of an internal control system) care should be taken to minute that the directors:

- Considered all relevant stakeholders;
- Took into account the matters which they ought to take into account;
- Took advice where necessary;
- Acted reasonably in relying on others;
- Acted on proper information.

5.11 The role of the company secretary

The Companies Act 2006 (the Act) introduced a number of changes to the world of the Company Secretary. Part 12 of the Act, the part relating to Company Secretaries, came into force on 6 April 2008, other than sections 270(3)(b)(ii) and 275–279, which will come into force on 1 October 2009.

Prior to this, section 283 of the Companies Act 1985 required every company to have a secretary. A sole director was prohibited from being company secretary. A company was also prohibited from:

- Having as its secretary a corporation, the sole director of which is a sole director of the company;
- Having as its sole director a corporation, the sole director of which is secretary to the company.

The main substantive change in the 2006 Act is that private companies are no longer required to have a company secretary (although they may still choose to have one). Only public companies are now required by statute to have a company secretary. The provisions of Part 12 of the 2006 Act relating to secretaries only therefore apply in respect of public companies and those private companies that choose to have a secretary.

On 24 October 2008, the Institute of Chartered Secretaries and Administrators (ICSA) published a guidance note on the

corporate governance role of the company secretary, which includes a section on Companies Act compliance. The note includes:

- The relevant Combined Code provisions;
- A list of responsibilities which should be assumed by the company secretary in helping the chairman comply with the Code;
- A list of duties in relation to other statutory and regulatory compliance responsibilities (such as the duties of directors, share dealing, the protection of inside information, the verification of published information and the release of market information);
- Duties in relation to guidelines issued by institutional investors.

The guidance replaces ICSA's 2002 note ''Specimen job description for the Corporate Governance Role of the Company Secretary''. It draws attention to the increasing trend for responsibility for developing and implementing 'processes to promote and sustain good corporate governance to fall to the company secretary'. It goes on to say that '*the most effective company secretary is one who is regarded by the Board as its trusted adviser and who:*

- *keeps under review legislative, regulatory and governance developments that may impact the company and ensures that the board is appropriately briefed on them;*
- *wins the confidence of and acts as a confidential sounding board to the chairman and other directors on issues of concern; and*
- *provides, where appropriate, a discreet but challenging voice in relation to board deliberations and decision making, drawing in particular on his or her professional experience and historical knowledge of the company*'.

The abolition of the requirement for private companies to have a company secretary is part of the wider amendments in the 2006 Act aimed at simplifying the regime applicable to private companies and providing private companies with a greater degree of flexibility in relation to their internal administrative arrangements. Although it is no longer

mandatory for a private company to have a secretary, this will not prevent a private company from appointing or retaining a company secretary should it wish to do so. Indeed, it is expected that many of the larger private companies will retain a company secretary.

5.12 The Audit Committee

A very wide range of tasks can be assigned to an Audit Committee – sometimes so wide that the committee might find itself too overloaded with work to do any part of it well. Setting out clear terms of reference can avert this problem, targeting time at major issues and ensuring that the committee is always well-briefed about key reporting and auditing issues.

The role of the audit committee will vary from company to company and should be tailored to the individual circumstances of the company. It is for the board to decide the role undertaken by the audit committee. Some guidance on this is available through the Combined Code (the Code), which we encountered in Chapter 2.

The audit committee is intended to provide a link between the auditor and the board, independent of the company's executives, since the latter are responsible for the company's accounting rules and procedures that are the subject of the audit. The committee may thus help the board discharge its responsibility with regard to the validity of published statements.

The Code sets out that the role of the audit committee should be:

- To monitor the integrity of the financial statements of the company, reviewing significant financial reporting judgements;
- To review the company's internal financial control system and, unless expressly addressed by a separate risk committee composed of independent directors, or by the board itself, to review the company's internal control

and risk management systems (this will probably include consideration of the risk management plan drawn up jointly with internal audit, the internal audit plan, review of any important new systems (for example, IT systems), scrutiny of environmental or business ethics issues and examining procedures for fraud detection and prevention);

- To monitor and review the effectiveness of the company's internal audit function;
- To make recommendations to the board in relation to the external auditor's appointment and approve the remuneration and terms of engagement of the external auditor;
- To monitor and review the external auditor's independence, objectivity and effectiveness, taking into consideration relevant UK professional and regulatory requirements;
- To develop and implement policy on the engagement of the external auditor to supply non-audit services, taking into account relevant ethical guidance regarding the provision of non-audit services by the external audit firm.

Some companies may wish to add to this list – for example, some companies may choose to require the Audit Committee to monitor or make recommendations on:

- The potential implications of legal actions being taken against the company.
- The adequacy of arrangements for managing conflicts of interest.
- The expenses incurred by the chairman.
- Treasury management policies.

Some smaller companies may need to modify the list in other ways, and companies which have a US listing may need to amend the terms of reference in light of the requirements of the Sarbanes Oxley Act of 2002. Audit Committees should also have regard to the prevailing market conditions in carrying out their role.

The Financial Reporting Council (FRC)'s Guidance on Audit Committees, available from the FRC provides more detail of the audit committee's role (see *section 4, Role and responsibilities, FRC Guidance on Audit Committees*) and its

relationship with the board (see *section 3, Relationship with the board, FRC Guidance on Audit Committees*).

It should be noted that it is not the role of the audit committee to carry out functions that belong to others, such as the management's preparation of the financial statements or the auditors planning or conducting of audits (*paragraph 1.9, FRC Guidance on Audit Committees*).

Where applicable, the FSA's Disclosure and Transparency Rule DTR 7.1.3R requires the audit committee to monitor the financial reporting process, the effectiveness of the issuer's internal control, internal audit where applicable, and risk management systems, the statutory audit of the annual and consolidated accounts, and to review and monitor the independence of the statutory auditor, and in particular the provision of additional services to the issuer.

The Code contains the following provisions on the duties of the audit committee:

- **Whistleblowing**. The audit committee should review arrangements by which company staff may raise concerns in confidence about possible improprieties in financial reporting and other matters; and it should ensure that arrangements are in place for the proportionate and independent investigation of such matters and for appropriate follow-up action (*Code Provision C.3.4*).
- **Internal audit**. The audit committee should monitor and review the effectiveness of the internal audit activities. Where there is no internal audit function the committee should consider annually whether there should be one and make a recommendation to the board; the reasons for the absence of such a function should be explained in the annual report (*Code Provision C.3.5*). (A review of the effectiveness of internal audit will involve ensuring that internal audit is independent of the functions it audits and that it has unfettered access to all company activities, ensuring that internal audit has an adequate budget, examining the quality of the work produced by internal audit and the management response to it).

- **External audit**. The audit committee should have primary responsibility for making recommendations to the board in relation to the external auditor's appointment; if the board rejects the recommendations, the committee and the board should explain their respective positions in the annual report (*Code Provision C.3.6*).

Much of the detail of the specific duties of the committee is set out in the Financial Reporting Council's Guidance on Audit Committees under the following headings:

- Financial reporting;
- Internal controls and risk management systems;
- Whistleblowing;
- The internal audit process;
- The external audit process;
  - Appointment,
  - Terms and remuneration,
  - Independence, including the provision of non-audit services,
  - Annual audit cycle.

The Code requires the establishment of an audit committee of at least three members (two in the case of smaller companies) who should all be independent directors and one of whom should have recent and relevant financial experience. In smaller companies, the 2008 version of the Code states that the company chairman may be a member of, but not chair, the committee in addition to the independent non-executive directors, provided he or she was considered independent on appointment as chairman.

The Code recommends that the main role and responsibilities of the Audit Committee should be set out in written terms of reference and these should be made available on request and on the company's website. A separate section of the annual report should describe the work of the Audit Committee (*Code Provisions C.3.1 and C.3.2*).

Terms of reference should be tailored to the particular circumstances of the company and should be reviewed by the Audit Committee annually. Both the committee itself and the

board should review the effectiveness of the Audit Committee (*paragraphs 3.2 to 3.4, FRC Guidance on Audit Committees*.

For reporting periods beginning on or after 29 June 2008, the FSA's Disclosure and Transparency Rules (DTR), in DTR 7, include requirements for issuers whose transferable securities are admitted to trading and which is required to appoint a statutory audit or (subject to some exceptions):

- To have a body responsible for carrying out audit functions (*DTR 7.1.1R*) and
- To issue a statement identifying the body which carries out the audit functions and describes how that body is composed (*DTR 7.1.5R and 7.1.5G*).

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Disclosure and Reporting Responsibilities

6.1 The trends in reporting – increasing focus on non-financial matters

Increasingly, on top of the reasonably familiar financial reports which have long been a feature of reporting obligations, companies are considering types of non-financial reporting – for example, environmental and social reporting. So far, there are few agreed standards for environmental and social reporting (except for certain disclosures which are required, for example, provisions for remediation such as land clean-up costs and charitable and political donations). Such a report can, however, be audited, to add extra credibility, either by an external verifier, or by the internal audit department.

Non-financial reporting, in particular reporting on social, environmental and ethical issues has been considered by the Association of British Insurers (ABI). In October 2001, the ABI first published a set of investment guidelines aimed at encouraging companies to disclose in their annual report whether, and if so, how, they take into account the significance of social, environmental and ethical (SEE) issues (the SEE Guidelines).

The SEE Guidelines were unveiled at the same time as research commissioned by the ABI on corporate social responsibility ('*Investing in Social Responsibility: Risks and Opportunities*'). The report argued that there are two business cases for corporate social responsibility:

- The enhancement of shareholder value by addressing risks posed by environmental impacts, poor labour conditions, human rights abuses and bad management of stakeholders. (The report acknowledges that quantifying such risks may be difficult, as they can be more 'issues driven' rather than directly performance related, and sets out a suggested approach).
- The potential for competitive advantage, an argument that has already persuaded a number of major companies to promote corporate social responsibility policies.

In February 2007, the ABI published its Responsible Investment Disclosure Guidelines which are intended to update and replace the SEE Guidelines.

The Responsible Investment Disclosure Guidelines apply to all listed companies and introduce changes to reflect the EU Accounts Modernisation Directive (*2003/51/EC*), the Companies Act 2006, recent experience of narrative reporting and the clarification by the Government of directors' liability for narrative statements. However, the new guidelines do not involve substantial changes to the SEE Guidelines. Changes include the insertion of questions as to whether the annual financial report:

- Contains a forward-looking assessment of environmental, social, governance (ESG) or other risks facing the company (ESG replaces the reference to SEE risks in the previous guidelines);
- Describes the role of the board in overseeing risk management;
- States whether the company has followed ASB guidance on narrative reporting;
- States whether the company produces key performance indicators (KPIs) on material ESG risks, and such KPIs for each business unit.

The ABI has stated that the Responsible Investment Disclosure Guidelines are not intended to set a limit on the amount of information companies should provide on their response to ESG matters, and acknowledges that some shareholders with specific ethical investment objectives may seek additional information and that some companies may choose to make additional information available (for example, through separate corporate responsibility reports) in order to enhance their appeal to investors. As ABI members account for more than a fifth of investments in the London stock market, listed companies are likely to take note.

The momentum towards companies extending their best practice remit to include risks associated with SEE and ESG matters has gained pace in recent years. Regulations requiring pension scheme trustees to disclose their policies on SEE considerations came into force in July 2000 (*The Occupational Pension Schemes (Investment and Assignment, Forfeiture, Bankruptcy etc) Amendment Regulations 1999*). In May 2001, the National

Association of Pension Funds (NAPF) published a charter for members to assess the ethical performance of companies, and the FTSE 4 Good, a new index series for socially responsible investors was launched at the end of July 2001.

Also, in November 2002, the ABI, British Bankers Association and a number of leading financial institutions launched FORGE Guidance on Corporate Social Responsibility Management and Reporting for the Financial Services Sector.

The Companies Act 2006, as we saw in Chapter 4, includes a statutory statement of directors' duties, effective from 1 October 2007. In section 172 of the Companies Act 2006, the duty to act in the way which would be most likely to promote the success of the company for the benefit of its members includes a list of material factors which a director must consider, including the company's need to have regard to the impact of its operations on the community and environment. The purpose of the business review requirements of the Companies Act 2006 (effective for accounting periods beginning on or after 1 October 2007) is to assess how the directors have performed this duty.

In November 2007, the NAPF published updated Corporate Governance Policy and Voting Guidelines which for the first time include high level guidance on ESG in recognition of its importance to pension funds and other investors. In its guidelines the NAPF endorses the UN Principles for Responsible Investment which provides a framework for incorporating ESG issues into mainstream investment decisions and is supportive of government-sponsored initiatives such as the Extractive Industries Transparency Initiative and the Carbon Trust's Carbon Disclosure Project.

The government has also appointed a minister for corporate social responsibility and has a website which illustrates examples of good business practice, gives sources of information, advice and information of government activity on corporate social responsibility (*www.csr.gov.uk*).

Some corporations are choosing to have their reports of corporate social responsibility policy implementation audited

(or verified) by external third parties. The evolution of environmental reporting in particular has led to a proliferation in the number of organizations providing verification services linked to specific standards.

6.2 Financial reporting matters

Here we will consider the requirements for companies to prepare annual accounts and reports under Part 15 of the Companies Act 2006 (the Act), for financial years beginning on or after 6 April 2008.

6.2.1 Obligation to keep accounting records

All limited and unlimited companies, whether or not they are trading, must keep adequate accounting records (section 386(1) of the Act). Adequate accounting records are records that are sufficient to:

- Show and explain the company's transactions;
- Disclose with reasonable accuracy, at any time, the company's financial position at that time;
- Enable the directors to ensure that any accounts required to be prepared comply with the 2006 Act (and, where applicable, Article 4 of the IAS Regulation, which requires companies with securities traded on an EU regulated market to prepare their consolidated accounts, for financial years beginning on or after 1 January 2005, on the basis of international accounting standards adopted by the EU) (section 386(2));
- Failure to keep adequate accounting records is a criminal offence for every company officer in default (section 387);

Part 15 of the Act sets out the obligations relating directly and indirectly to the accounts or financial information to be provided by a company to its members (and others) and the Registrar of Companies. Some of the obligations in the Act are imposed directly on the directors and others on the company as an entity, although the directors will still be responsible for ensuring that the company complies with them.

The Act is structured so that it draws a distinction between those provisions which apply to:

- Small companies;
- Public companies. These are companies limited by shares or guarantee which have either been incorporated as a public company or re-registered as such (section 4); and
- Quoted companies. These are companies whose equity share capital has been included in the Official List in accordance with Part 6 of the Financial Services and Markets Act 2000, or is officially listed in an EEA state, or is admitted to dealing on either the New York Stock Exchange or NASDAQ (section 385(2)).

The Act also draws a distinction between the requirements for:

- Companies Act accounts. These are accounts prepared under the Act in accordance with and
- IAS accounts. These are accounts prepared in accordance with international accounting standards (IAS) – also known as International Financial Reporting Standards (IFRS) – as adopted by the EU.

6.2.2 Regulations

The Act is structured so that many of the content and format requirements for company accounts are specified in regulations made by the Secretary of State under it. These regulations also implement parts of several EU Directives.

The regulations came into force on 6 April 2008 and, with one exception (with respect of the directors' remuneration report disclosure requirement in paragraph 4 of Schedule 8 to The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008), apply to financial years beginning on or after that date:

- **The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008** specify the form and content of the accounts and reports of all companies other than those subject to the small companies regime (see Small Companies and Groups (Accounts and Directors'

Report) Regulations 2008 below). The regulations replace provisions previously contained in the Schedules of Part 7 of the Companies Act 1985. The regulations implement the Accounting Directives (78/660/EC and 83/349/EC), Council Directive 86/635/EEC on the annual accounts and consolidated accounts of banks and other financial institutions (Bank Accounts Directive), Council Directive 91/674/EEC on the annual accounts and consolidated accounts of insurance undertakings (Insurance Accounts Directive), and Articles 1.5, 1.6(7b), 3 and 4 of the Directive 2006/46/EC (Company Reporting Directive). They make the following substantive changes to the previous requirements of the Companies Act 1985:

- Disclosure of turnover. The exemption for medium-sized companies in the Companies Act 1985 from disclosing turnover in abbreviated profit and loss accounts delivered to the registrar of companies has been removed (regulation 4(3)(a)), but there is still exemption from disclosing detailed particulars of turnover in the notes to such accounts (regulation 4(3)(b)).
- Group accounts. Technical amendments have been made to the group accounts' provisions to address the potential for differences in the context of UK accounting standards being converged with IFRS (paragraphs 9, 13 and 17, Schedule 6).
- Political donations. The threshold for disclosure of political donations and expenditure and charitable donations has been raised from £200 to £2000; and a new disclosure requirement for donations to independent election candidates has been introduced to take into account the provisions in Part 14 of the 2006 Act (paragraphs 3–5, Schedule 7).
- Directors' remuneration report. For financial years beginning on or after 6 April 2009, quoted companies will have a new requirement to state in their directors' remuneration report on how they have taken pay and employment conditions elsewhere in the group into account when setting directors' pay (regulation 2(3) and paragraph 4, Schedule 8).

- Fair value. Companies are given the option of including financial instruments in the accounts at fair value in certain circumstances (implementing Article 1.5 of the Company Reporting Directive) (paragraph 36(4), Schedule 1, paragraph 44(4), Schedule 2 and paragraph 30(4), Schedule 3).
- Related parties. A new requirement is introduced to implement Article 1.6 of the Company Reporting Directive, to make certain disclosures about transactions with related parties (paragraph 72, Schedule 1, paragraph 92, Schedule 2 and paragraph 90, Schedule 3), but medium-sized companies are exempt from this requirement (regulation 4(2)(b)).

The main body of these regulations outlines the basic accounting requirements that apply to companies other than small companies and indicates certain circumstances in which companies can depart from these. The schedules to the regulations set out the following detailed requirements:

- Schedule 1: Companies Act individual accounts (companies that are not banking or insurance companies);
- Schedule 2: Banking companies: Companies Act individual accounts;
- Schedule 3: Insurance companies: Companies Act individual accounts;
- Schedule 4: Information on related undertakings (Companies Act or IAS accounts);
- Schedule 5: Information about benefits of directors (Companies Act or IAS accounts);
- Schedule 6: Companies Act group accounts;
- Schedule 7: Matters to be dealt with in the directors' report;
- Schedule 8: Quoted companies: directors' remuneration report;
- Schedule 9: Interpretation of term 'provisions';
- Schedule 10: General interpretation.
- **The Small Companies and Groups (Accounts and Directors' Report) Regulations 2008** specify the form and content of the accounts and directors' report of companies subject to the small companies' regime under Part 15 of

the 2006 Act. The regulations replace provisions previously contained in the Schedules to Part 7 of the Companies Act 1985. The regulations implement Article 1.5 of the Company Reporting Directive. They make the following changes to the requirements as they were under the Companies Act 1985:

- Group accounts. Technical amendments have been made to the provisions on group accounts to address the potential for differences in the context of UK accounting standards being converged with IFRS (paragraphs 9, 13 and 17, Schedule 6).
- Political donations. The threshold for disclosure of political donations and expenditure and charitable donations has been raised from £200 to £2000; and a new disclosure requirement for donations to independent election candidates has been introduced following the provisions in Part 14 of the 2006 Act (paragraphs 2–4, Schedule 5).
- Fair value. Companies are given the option of including financial instruments in the accounts at fair value in certain circumstances (implementing Article 1.5 of the Company Reporting Directive) (paragraph 36(4), Schedule 1).

The main body of these regulations outlines the basic accounting requirements that apply to small companies and indicates certain circumstances in which small companies can depart from these. The schedules to the regulations set out the following detailed requirements:

- Schedule 1: Companies Act individual accounts;
- Schedule 2: Information about related undertakings where company is not preparing group accounts (Companies Act or IAS individual accounts);
- Schedule 3: Information about directors' benefits: remuneration (Companies Act or IAS accounts);
- Schedule 4: Companies Act abbreviated accounts for delivery to the registrar of companies;
- Schedule 5: Matters to be dealt with in the directors' report;
- Schedule 6: Group accounts; Schedule 7 – Interpretation of term 'provisions'; Schedule 8 – General interpretation;

- The Insurance Accounts Directive (Miscellaneous Insurance Undertakings) Regulations 2008. These regulations are made under section 2(2) of the European Communities Act 1972. They apply to insurance undertakings (broadly, bodies incorporated or registered under statute which require permission under Part 4 of the Financial Services and Markets Act 2000 (FSMA) to effect or carry out contracts of insurance and are not required to prepare accounts under Part 15 of the 2006 Act) which are incorporated in or formed under the law of any part of the UK. The regulations ensure that insurance undertakings are subject to the same accounting requirements as insurance companies subject to the 2006 Act;
- The Bank Accounts Directive (Miscellaneous Banks) Regulations 2008 (SI 2008/567). These regulations are made under section 2(2) of the European Communities Act 1972. The regulations ensure that certain banking entities (qualifying banks) are subject to the same accounting and auditing requirements as banking companies which are subject to the 2006 Act. For these purposes, a qualifying bank is broadly, any body of persons incorporated or formed by or established under statute passed before the year 1837, which has a principal place of business within the UK, is an authorised deposit taker and is not required to prepare accounts under Part 15 of the Act;
- The Partnerships (Accounts) Regulations 2008 (SI 2008/569). These regulations apply to qualifying partnerships (broadly, partnerships governed by the laws of any part of the UK where each of its members is either a limited company, or an unlimited company or a Scottish partnership, each of whose members is a limited company);
- The Companies (Summary Financial Statement) Regulations 2008 (SI 2008/374). These regulations concern the summary financial statements which companies may send out in place of their full accounts and reports. They are made under sections 426–428 in Part 15, and 1292(1) and (4) in Part 46 of the Act;
- The Companies Act 2006 (Amendment) (Accounts and Reports) Regulations 2008 (SI 2008/393). These regulations implement parts of the Company Reporting Directive. They

increase the financial thresholds for qualification as small and medium-sized companies and groups and exemption from audit, and make transitional provision to enable companies to take early advantage of the new financial thresholds for small- and medium-sized companies. The regulations also reinstate certain exemptions relating to the directors' report for small- and medium-sized companies which were inadvertently omitted from the Act and they introduce a new section 410A on disclosure in the notes to the accounts of off-balance sheet arrangements for companies other than small companies. The regulations also introduce a provision whereby companies who have prepared IAS individual accounts may later prepare Companies Act individual accounts if the company ceases to be a subsidiary undertaking;

- The Companies (Late Filing Penalties) and Limited Liability Partnerships (Filing Periods and Late Filing Penalties) Regulations 2008 (SI 2008/497). These regulations determine the penalties which companies must pay to the Registrar of Companies for late filing of their annual accounts and reports and also set out the penalties for limited liability partnerships (LLPs) for late filing of their accounts and auditors' reports together with the filing periods for the accounts and auditors' reports of LLPs (see Late delivery);
- The Companies (Revision of Defective Accounts and Reports) Regulations 2008 (SI 2008/373). These regulations set out how the provisions of the Act are to apply to revised annual accounts, directors' reports, directors' remuneration reports and summary financial statements. They replace the Companies (Revision of Defective Accounts and Report) Regulations 1990 (SI 1990/2570) and the Companies (Revision of Defective Accounts and Report) Regulations (Northern Ireland) 1991 (SR 1991/268).

6.3 Annual accounts and reports

The directors of every company must prepare company accounts for each financial year – these are the company's individual accounts (section 394 of the Act).

Companies Act individual accounts (that is, accounts for an individual company (as opposed to group) prepared in accordance with UK GAAP) comprise the balance sheet and the profit and loss account (section 396).

The term 'annual accounts' means the individual accounts (and notes to the accounts) required by section 394 together with any group accounts required by sections 398 and 399 (subject to an exemption in section 408 where there is the option to omit the individual profit and loss account where information is given in group accounts) (sections 471(1) and 472(2)).

Special provisions apply in respect of the annual accounts and reports of medium-sized and small (including very small) and dormant companies such that they may omit certain information from their accounts and file abbreviated accounts at Companies House. Very small companies and group companies and dormant companies may also be exempted from audit.

Unquoted companies

Generally, an unquoted company's annual accounts and reports consist of:

- Annual accounts (a balance sheet at the last day of the financial year (section 396(1)(a)), a profit and loss account (section 396(1)(b)) and notes to the accounts (section 472));
- A directors' report signed by a director or the company secretary (section 415);
- An auditor's report on those accounts and the directors' report (unless the company is exempt from audit) (section 495).

Quoted companies

A quoted company's annual accounts and reports consist of:

- Annual accounts;
- A directors' report;
- A directors' remuneration report;
- An auditor's report on those accounts, on the auditable part of the directors' remuneration report and on the directors' report (section 471(3)).

The term 'annual report', which is often used in relation to listed companies, means the directors' report required by section 415.

6.4 Applicable accounting standards

A company's individual accounts may be prepared in accordance with:

- Section 396. Such accounts are known as Companies Act individual accounts and they are prepared using UK GAAP or
- IAS as adopted by the EU. Such accounts are known as IAS individual accounts (section 395).

Generally, the directors of a parent company must ensure that the individual accounts of the parent and its subsidiaries are all prepared using the same financial reporting framework unless there are good reasons for doing otherwise (section 407).

Companies that are charities must prepare individual accounts in accordance with section 396, but other companies will generally have a choice. However, once they prepare their individual accounts in accordance with IAS, they must continue to do so for subsequent years unless there is a relevant change of circumstances (such as the company becoming a subsidiary of another undertaking that does not prepare IAS individual accounts) (sections 395(2)–(5)).

The group accounts of parent companies whose securities are admitted to trading on a regulated market in any EU member state must be prepared in accordance with IAS; and the group accounts of a parent company that is a charity must be Companies Act group accounts (section 403).

6.5 Accounting periods

A company produces its accounts by reference to the accounting period which ends on its accounting reference date (ARD).

Generally, a company's ARD is the last day of the month of the anniversary of the company's incorporation, but this can be altered (sections 391 and 392). Alteration of the ARD must be made by notice given to the registrar under section 392. Until section 1068(1) (registrar's requirements as to form, authentication and manner of delivery) comes into force (expected to be 1 October 2009), the notice referred to in section 392 must be given in the form prescribed for the purposes of section 225(1) of the 1985 Act (paragraph 8, Schedule 4, The Companies Act 2006 (Commencement No. 5, Transitional Provisions and Savings) Order 2007).

A company's first accounting reference period is a period of more than six months but not more than 18 months beginning with the date of incorporation and ending with the ARD unless the company changes its ARD in accordance with section 392 (section 391(5)). Subsequent accounting reference periods are successive periods of 12 months, subject to any alteration of the ARD (section 391(6)).

The first accounts of a company must cover the period starting on the date of incorporation (rather than the first day of trading) and ending on the company's ARD or up to seven days either side of that date. Subsequent accounts start on the day after the previous accounts ended; they finish on the ARD or up to seven days either side of it (section 390).

The ARDs of companies incorporated before 1 April 1996 (in the case of GB companies), and before 22 August 1997 (in the case of Northern Irish companies) are preserved by the 2006 Act (sections 391(2) and (3)).

6.6 Access to accounting records

The accounting records must at all times be open to inspection by the company's officers and must be kept at the company's registered office or such other place as the directors think fit (section 388(1)).

A company may keep accounting records in a place outside the UK provided that accounts and returns (which disclose the company's financial position at six monthly intervals and are

sufficient for ensuring compliance with the Act or where applicable Article 4 of the IAS Regulation) are sent to the UK and are open for inspection at all times by the company officers (sections 388(2) and (3)).

Generally members of a company do not have right of access to the accounting records but the company's articles may provide for members to be given such a right (see Article 109, Table A (applicable for companies adopting Table A before 1 October 2007) and The Companies (Model Articles) Regulations 2008 (applicable for companies incorporated on or after 1 October 2009)).

The company's auditors have a right of access to the accounts at all times (section 499).

A company must preserve its accounting records for three years from the date they were made in the case of a private company, and six years from that date for a public company (section 388(4)).

6.7 Approval and signature

Directors must approve the annual accounts of a company and are primarily responsible for their accuracy.

6.8 True and fair requirement

The directors have an overarching obligation not to approve accounts unless they give a true and fair view of the financial position of the company and, in the case of group accounts, the group (section 393).

6.9 Signature of accounts

The accounts and reports must be approved by the board and generally, they must be signed on behalf of the board by a director of the company, before being filed at Companies House:

- The signature must be on the balance sheet (section 414(2));
- If the accounts are prepared in accordance with the small companies regime, the balance sheet must contain a

statement to that effect in a prominent position above the signature (section 414(3));
- The directors' report and (in the case of quoted companies) the directors' remuneration report, must be signed by a director or the company secretary (sections 419(1) and 422(1)).

Every copy of the above documents that is published on behalf of the company must state the name of the person who signed it on behalf of the board (section 433).

Where an auditor's report, special auditor's report or accountants' report is attached to the accounts, it must state the names of the auditors or accountants and be signed by them (section 503(1)).

The detailed requirements for signature and authentication of the accounts and reports filed with the Registrar are contained in:

- Sections 444(6)–(7) for small companies full accounts and reports;
- Sections 445(5)–(6) for medium-sized companies full accounts and reports;
- Sections 446(3)–(4) for unquoted companies;
- Section 447(3)–(4) for quoted companies.

6.10 Directors' liability

If accounts are not reasonably accurate, every director who is in default is potentially criminally liable (to a fine and/or imprisonment) unless he can show that he acted honestly and the default was excusable (section 387 of the Act).

Directors may be criminally liable if they fail to prepare a directors' report which complies with the 2006 Act requirements (sections 415(4) and (5) and 419(3) and (4)). Similarly, if annual accounts are approved which do not conform to the requirements of the 2006 Act, or Article 4 of the IAS Regulation if applicable, every director who knew that they did not comply, or is reckless as to whether they complied and failed to take reasonable steps to secure compliance or

failed to prevent them from being approved, is guilty of a criminal offence and liable to a fine (sections 414(4) and (5)). It is also a criminal offence to make false statements to auditors (section 501).

If a company's accounts are found to be defective (for example, they did not give a true and fair view as required by section 396 of the Act), directors may also be liable under civil law for breach of statutory duty, or for failing to exhibit the requisite degree of skill that may reasonably be expected in the performance of their duties, or for breach of their duty to act in good faith to promote the success of the company (although, in practice, it will be difficult to prove that the company suffered a loss as a result of these breaches). A shareholder might then be able to sue the director on the company's behalf using the derivative claim procedure under section 260 of the Act.

6.11 Laying of accounts by private and public companies

There is no statutory obligation on private companies to lay their accounts and reports before general meeting. This is because there is no longer a statutory requirement for private companies to hold AGMs, but a private company may still hold an AGM pursuant to its articles.

The directors of public companies must lay copies of their annual accounts and reports before the company in general meeting (section 437).

The time period for laying the accounts by public companies before general meeting is the same as the time periods for the filing of the accounts with the Registrar of Companies.

If the requirements are not complied with before the end of the period allowed, the directors are liable to a fine and, for continued contravention, a daily default fine (section 438). It is a defence for a director to prove that he took all reasonable steps for securing that those requirements would be complied with before the end of that period (section 438(2)).

6.12 Resolution

There is no statutory requirement for a resolution on the accounts and reports to be put to the general meeting. However, articles of association have traditionally included a requirement that the report and accounts be adopted by the company in general meeting, that is, that there should be a vote. Most companies have now removed this requirement from their articles, but continue to hold a vote. The Combined Code provides that the board should propose an AGM resolution relating to the report and accounts (provision D.2.1, Combined Code).

The statutory obligation for public companies is to lay the accounts before the company. Accordingly, it is technically quite acceptable for the resolution simply to state that the company will 'receive' the report (or reports) and accounts, so long as the articles do not require 'adoption'. However, the resolution may state that the company will 'receive and adopt', 'consider and adopt' or even 'receive, consider and adopt' the report (or reports) and accounts. The wording will need to take account of any requirement contained in the articles, but any of these alternatives is more than sufficient to meet the statutory requirement.

6.13 Sending copies of accounts to members

Copies of the annual accounts and reports must be sent to members, debenture holders and everyone entitled to receive notice of general meetings (section 423 of the Act). They must also be sent to nominated persons under section 145.

Copies need only be sent to persons for whom the company has a current address. This is to avoid companies having to send copies of the annual accounts and reports to addresses from which correspondence has previously been returned marked 'not known at this address' (or its electronic equivalent).

The time allowed for sending out copies of the annual accounts and reports is:

- In the case of a private company, not later than either the end of the period for filing accounts and reports, or if

earlier, the date on which it actually delivers its accounts and reports to the Registrar;

- In the case of a public company, at least 21 days before the date of the meeting at which copies of the documents are to be laid in accordance with section 437 (known as the accounts meeting) (section 424).

If, in the case of a public company, copies are sent out later than is required by section 424, they shall, despite that, be deemed to have been duly sent if it is so agreed by all the members entitled to attend and vote at the relevant accounts meeting.

Under sections 1144(2) and (3) of the Act, the annual accounts and reports must be sent or supplied by the company in accordance with Schedule 5 (in hard copy or electronic form (see below)).

All companies may, in certain circumstances, send a summary of financial statement to members and debenture holders and any other person entitled to receive the accounts instead of the full statutory accounts.

6.14 Electronic form

Since 20 January 2007, the Act has allowed companies to use electronic communications with shareholders as the default position, so that they can put their annual accounts and reports on their website and need not send hard copies to the shareholders (section 1144 and Schedule 5). To make use of these new provisions, companies must first change their articles of association or pass a shareholder resolution allowing such use of the website.

6.15 Disclosure rules and transparency rules (DTR)

The electronic communications provisions in the Act need to be read alongside the electronic communications provisions in the Disclosure Rules and Transparency Rules (DTR) which

apply to issuers with transferable securities admitted to trading on a regulated market. The DTR provide that if a company uses electronic means to communicate with shareholders there are certain procedures with which it must comply (see DTR 6.1.8R). These include that the decision to use electronic means must be taken in general meeting. The DTR make it clear that an issuer can continue to rely on a shareholder authorisation to use electronic communications that was obtained before 20 January 2007.

6.16 The right to demand copies of accounts and reports

A member or debenture holder may demand a single copy of the most recent annual accounts and reports (including the directors' remuneration report in the case of a quoted company) free of charge (sections 431 and 432). This right is in addition to any copy to which the person may be entitled under section 423 (Duty to circulate copies of annual accounts and reports) (see Sending copies of accounts to members). Failure to comply with the demand within seven days of receipt of the request by the company may result in a criminal offence for the company and its directors.

Where a registered member of a traded company has nominated the beneficial holder of the shares to enjoy information rights, one of those rights is the right to require copies of accounts and reports under sections 431 and 432 (section 146).

6.17 Delivery of accounts to the registrar of companies

Subject to exemptions for small, medium-sized and dormant companies, in respect of each financial year, all private and public limited companies must send to the Registrar of Companies copies of the following:

- The company's annual accounts;
- The directors' report for that year;

- In the case of a quoted company, the directors' remuneration report;
- The auditor's report on those accounts (sections 444–447).

Unlimited companies may keep their financial affairs confidential and are not required to deliver accounts to the Registrar unless, during the period covered by the accounts, the unlimited company was:

- A subsidiary or a parent of a limited undertaking.
- A banking or insurance company (or the parent company of a banking or insurance company);
- A qualifying company within the meaning of the Partnerships and Unlimited Companies (Accounts) Regulations 1993 (SI 1993/1820) (section 448).

Where the accounts are not the first accounts of the company, the period for filing with the Registrar is:

- For a private company, nine months from the ARD;
- For a public company, six months from the ARD (section 442(2)).

Where the company's first accounts cover a period of more than 12 months, the period for filing is the longer of:

- For a private company, nine months, and for a public company, six months, from the first anniversary of the company's incorporation (that is, within 21 months of the date of incorporation for private companies and within 18 months of the date of incorporation for public companies); or
- Three months after the ARD (section 442(3)).

Where the accounting reference period has been shortened by alteration of the company's ARD, the time allowed for filing the accounts is the longer.

- For a private company, nine months, or for a public company, six months from the ARD; or
- Three months from the date of the notice altering the ARD under section 392 (section 442(4)).

The Act sets out how to calculate the filing period (section 443). Generally, the period ends with the date in the

appropriate month corresponding to the specified date or last day of the specified previous period. If the specified date, or the last date of the specified previous period is the last day of the month, the period ends with the last day of the appropriate month, whether or not that is the corresponding date. So, a private limited company with an accounting reference date of 30 April has until 31 January to file its accounts and a private limited company with an accounting reference date of 28 or 29 February has until 30 November. This is different from the rules under the Companies Act 1985, where the last date for filing was the corresponding date in the filing month.

The company may make a written application to the Secretary of State for Trade and Industry to extend the time for laying and delivering accounts if there is a special reason for doing so, for example, if there has been an unforeseen event which was outside the control of the company and its auditor (section 442(5)). Such an application must be delivered before the expiry of the company's filing deadline, and must contain an explanation of the reasons for the extension and the length of extension required.

The accounts do not have to be laid before the company in general meeting (in the case of public companies) or be agreed by HM Revenue and Customs before they are sent to Companies House.

Accounts and reports may be delivered to the Registrar by electronic means.

6.18 Late delivery

Where a company fails to deliver its accounts and reports to the Registrar of Companies within the required time, it is liable to an automatic civil penalty. The amount of the penalty is determined, in accordance with regulations made by the Secretary of State, by the length of delay in filing and whether the company is public or private (section 453(2)).

Failure to deliver accounts on time is a criminal offence for which the directors may be prosecuted (section 451) and there are powers for the court to order the directors to comply with their filing duties (section 452).

On 20 July 2007, Companies House published a consultation document setting out a schedule of late filing penalties under the 2006 Act, and on 7 January 2008, it published its response to the consultation. The penalties are introduced in regulations made under section 453(2). The Companies (Late Filing Penalties) and Limited Liability Partnerships (Filing Periods and Late Filing Penalties) Regulations 2008 (SI 2008/497) provide for:

- An increase in all penalties to take account of inflation between 1992 and 2007 (tables of the penalties are set out in the regulations);
- A faster rate of increase in penalties for companies who are more than one month late in delivering their accounts.

The penalty is to be double for any company which files late where it has also filed its accounts late in the previous year.

The first two changes came into force on 1 February 2009 (applying to accounts filed under either the Companies Act 1985 or the new Act). Repeat offender penalties will only apply once a company has filed late accounts in successive years under the new Act.

Under the regulations, where a company filed its accounts and reports under the 2006 Act before 1 February 2009, the late filing penalties were:

Length of delay	Public company	Private company
3 months or less	£500	£100
3 months one day to 6 months	£1000	£250
More than 6 months	£2000	£500

Where a company files its accounts and reports under the 2006 Act on or after 1 February 2009, the late filing penalties are now:

Length of delay	Public company	Private company
1 month or less	£750	£150
1 month one day to 3 months	£1500	£375
3 months one day to 6 months	£3000	£750
More than 6 months	£7500	£1500

Where accounts are filed on or after 1 February 2009 and there was also a failure to comply with the filing requirements of the previous financial year (which had begun on or after 6 April 2008), the late filing penalties are double the amounts shown in the above table.

Companies House has published a booklet giving guidance on the procedure for appeals against late filing penalties (Late Filing Penalties Appeals, GBA11, July 2008).

6.19 Publication of statutory and non-statutory accounts

The Act sets out rules for the publication of a company's statutory and non-statutory accounts. Publishing a document in this context is where a company publishes, issues or circulates it or otherwise makes it available for public inspection in a manner calculated to invite members of the public generally (or any class of them) to read it (section 436(2)).

6.20 Statutory accounts

Statutory accounts are the accounts required to be delivered to the Registrar of Companies under section 441 (section 434(3)). They differ depending on whether the company is small or medium-sized, or quoted or unquoted.

Any publication of the company's statutory accounts must be accompanied by the auditor's report on those accounts unless the company is exempt from audit and has taken advantage of the exemption (section 434(1)).

Where the company prepares statutory group accounts it must publish its statutory individual and group accounts together (section 434(2)).

6.21 Non-statutory accounts

Non-statutory accounts are, excluding those published as part of the company's statutory accounts, any balance sheet or

profit and loss account relating to a financial year of the company, or any account in any form purporting to be a balance sheet or profit and loss account for a group headed by the company relating to a financial year of the company (section 435(3)).

Where a company publishes non-statutory accounts, it:

- Must publish with them, a statement indicating that they are not the company's statutory accounts, whether statutory accounts for that financial year have been delivered to the Registrar of Companies, whether there is an auditor's report on the statutory accounts and whether it is qualified or unqualified;
- Must not publish with them, the auditor's report on the statutory accounts.

6.22 Revision of defective accounts and reports

Voluntary revision: The directors of the company may prepare revised annual accounts, directors' reports, directors' remuneration reports and summary financial statements if the original versions did not comply with the requirements of the Act (or, where applicable, Article 4 of the IAS Regulation) (section 454(1)).

Where copies of the original accounts or reports have been sent to members, delivered to the Registrar or (in the case of public companies) laid before general meeting, the revisions must be confined to:

- The correction of those respects in which the original accounts or reports did not comply and
- The making of any necessary consequential amendments (section 454(2)).

The Secretary of State has made provision in regulations as to the application of the Act to revised annual accounts and reports and summary financial statements in The Companies (Revision of Defective Accounts and Reports) Regulations 2008 (SI 2008/373). They allow the directors to correct the original defective accounts and reports by either:

- Replacement of the accounts and reports in substitution for the originals or
- A supplementary note indicating the corrections to be made to the originals.

Among other things, the regulations make detailed provisions for:

- Revised accounts to be prepared as if they were being prepared as at the date of approval of the original defective accounts;
- The procedures to be adopted for approval and signing of revised accounts and reports;
- The statements to be inserted into the revised documents;
- Publication, delivery and (in the case of public companies) laying of the revised documents.

The regulations include special provisions where, before the revision, abbreviated accounts or summary financial statements had been sent out based on the original defective accounts and reports.

Under the regulations, as from the date of revision, the revised accounts and reports are to be regarded as the company's annual accounts and reports for the purposes of the Act.

Secretary of State's notice: The Secretary of State may give notice to the directors of a company if there is or may be a question as to whether the annual accounts or directors' report comply with the requirements of the Act or, where applicable, Article 4 of the IAS Regulation (section 455). The directors will then have one month to give an explanation or prepare revised accounts or a revised report. Where the directors do not respond satisfactorily, the Secretary of State may apply to court for a declaration that the accounts and report do not comply with the Act or the IAS Regulation, as appropriate, and the court may order preparation of revised accounts and report and give directions as it thinks fit.

Court application: The Secretary of State has power to authorise a person for the purposes of section 456 to apply to the courts to require the directors of companies to prepare revised accounts and reports where the original accounts or

reports were defective. The Financial Reporting Review Panel (FRRP) is the only authorised person for these purposes. (On 5 June 2008, the FRRP announced its approach to the review of accounts whose audit report is qualified for failure to comply with the 1985 Act and on 1 August 2008, the FRRP published its revised operating procedures.)

The Commissioners for Her Majesty's Revenue and Customs may disclose information to the FRRP in order to facilitate the court application (section 458).

We will now turn our attention to some non-financial reporting matters.

6.23 The enhanced business review

For financial years beginning on or after 1 October 2007, a quoted company has been required to produce an 'enhanced business review' (EBR) as part of its directors' report (*section 417(5), Companies Act 2006 – ('the Act')*).

The company's sector and business will be key drivers as to what it reports. There is a wide spectrum of what companies were already doing in their business review reporting on environmental, employee and social and community issues, and consequently what changes they made in order to comply with the EBR post-Act. The following checklist may be of help to those responsible for preparing such reports:

- Identify which corporate social responsibility (CSR) areas, and which particular aspects of these, will be 'necessary' to report on for an understanding of the development, performance or position of the business;
- If necessary, identify and ensure that you will be able to make a report:
  - Using Key Performance Indicators (KPIs) including information on environmental and employee matters;
  - On information on environmental matters including impact, employees and social and community matters, in each case mentioning policies and their effectiveness.
- In relation to each area and aspect considered necessary to report on, consider:

  - Whether any new policies need to be drafted or existing ones amended and how their effectiveness should be measured and reported on;
  - How to secure data and information to enable KPIs, impact and effectiveness to be measured. This should be done on a regular basis. To do this only once a year for the business review might secure suggest that the area and aspect is not actually necessary for an understanding of the business. There is also arguably an implicit assumption that year on year these reported measurements should improve. This perhaps reflects the view that businesses need to do more and even the most responsible of businesses need to continually up their game.
- Reporting on employees, policies and practices and KPIs might include:
  - Health and safety (for example, reportable injury rates);
  - Staff training (for example, hours spent);
  - Staff recruitment, retention and skills issues (for example, staff turnover/retention rates and career development initiatives);
  - staff engagement (for example, numbers on consultative committees, in shares plans or involved in community initiatives);
  - diversity and equal opportunities policies (for example, success of attempts to recruit from specific groups or reduce barriers to employment);
  - flexible working policies (for example, percentage of staff on flexible contracts);
  - results of staff surveys.
- Reporting on the environment, which even more than employees and social/community issues can be very dependent on the nature of a company's business, could include:
  - sustainable sourcing issues (for example, increased use of sustainable raw materials and initiatives and partnerships involving fair trade or other groups);
  - waste issues (for example, reduction in landfill use and increase in recycling rates and in use of recycled components);

- energy conservation initiatives (for example, endorsement or achievement of recognised standards or codes and reduced usage rates).
- Reporting on social and community issues could cover policies on, investment in and involvement with, local communities (for example, number of staff involved or hours per employee spent and descriptions of projects and benefits to the company and community);
- Identifying and reporting on contractual or other arrangements essential to the business, as well as identifying such contracts and arrangements and any key issues and actions concerning them, could, if thought necessary, also cover:
  - Supply chain issues (for example, policies adopted, conventions adhered to and how progress is monitored, including use of respected local organisations to help in monitoring);
  - client/customer issues (for example, consumer protection and health policies and initiatives, client diversity policies, client retention figures, customer/client research and views and the company's response).
- Keep coming back to the core questions. For environmental, employee and social and community issues, is it necessary to report on the issue for an understanding of the development, performance or position of the company's business and for contractual and other arrangements subject to limited carve-outs under section 417(10) and (11) of the 2006 Act; and is it essential to the business?
- Consider also relevant investor group guidelines, and indications of what investors are looking for in your reporting. For example:
  - set CSR issues in the context of the whole range of risks and opportunities facing the company, showing that their potential significance to the company's value has been assessed;
  - look forward, not back – where are these policies taking you?
  - be credible and verified, and able to substantiate whatever claims you make.
- Consider where in the annual accounts to position this information. Historically, for many companies CSR

information has not been included in the main business review/operating and financial review, but rather in the short, almost miscellaneous items directors' report (although as a result of section 463 of the new Act (liability for false or misleading statements in reports) these are now often linked). As a result of the enhanced business review these matters may now start to appear in the business review with more of an attempt to show why and how they are important to the business and perhaps for some companies some of these matters, where relevant and necessary, may even appear within their divisional information;

- Consider what to do with all other CSR information. While the business review needs to be focused on the necessary/essential matters and in some cases may involve expanding information on CSR areas, in other cases it may involve seemingly bold decisions to remove information from annual accounts. A CSR review covering a wider range of issues and aimed at a wider range of stakeholders will in many cases still be very valuable and should be cross-referenced and linked to in the business review.

When companies are considering narrative reporting generally, as well as corporate social responsibility (CSR) reporting in particular, there is a variety of guidance that companies may find useful. This includes:

- **The Accounting Standards Board (ASB) Voluntary Reporting Statement on Operating and Financial Review (January 2006).** The ASB reminded quoted companies in a 10 January 2008 press release, of the need to of the need to comply with the enhanced business review reporting requirements of the Companies Act 2006 and reiterated its view that the reporting statement continues to represent best practice. The reporting statement includes the following guidance on CSR issues:
  - The business review should focus on matters relevant to members, but the directors should also consider reporting on issues relevant to other users (for example, customers, suppliers, employees, society) where because of the influence of those issues on the business's performance and its value, they are also significant to members;

- As part of its aim to help members assess the company's strategies and their potential to succeed, the business review should, to the extent necessary, include information on relationships with other stakeholders (for example, customers, suppliers, employees, contractors and communities) which, taking a broad view, are likely to influence the business's performance and its value;
- Even if management and monitoring of some risks (perhaps environmental and social and community issues for some businesses) is not considered to be a key performance indicator (KPI), the business review should include information on such areas supported with other evidence of performance against objectives if this significantly impacts the entity's reputation.

- The **ASB Review of Narrative Reporting by Listed Companies (2006)**. While somewhat out of date (there was no 2007 ASB review), the aim of this review was 'to highlight strengths and weaknesses of current reporting in the interests of widespread adoption of good practice'. It highlighted three key areas for improvement:
  - The identification of principal risks and uncertainties;
  - The need for forward-looking statements;
  - The need to improve KPIs to show how a company is managing its performance in this regard.
- The **Department for Environment, Food and Rural Affairs – environmental key performance indicators: reporting guidelines for UK business (2006)**. These guidelines highlight the fact that companies that measure, manage and communicate their environmental performance understand how to improve their processes, reduce their costs, comply with regulatory requirements and take advantage of new market opportunities. Reflecting this, the guidelines set out 22 environmental KPIs considered to be significant, together with a sector-based table showing which KPIs could be used by companies in specific sectors.
- The **Financial Reporting Review Panel (FRRP)**. The FRRP announced on 6 September 2007 the extension of its work on reviewing accounts to cover directors' reports including business reviews. Its next issued activity report may well cover its finding in this area, and be of help to companies.

- The **Financial Reporting Council Complexity and Relevance in Corporate Reporting Review (the complexity project)**. In July 2008, the Financial Reporting Council announced its complexity project. This will look at both financial and narrative aspects with a view to considering whether corporate reporting requirements are disproportionate to their intended benefits and whether there are opportunities for improvement. It will be interesting to see whether this results in any consensus on how to make annual reports shorter and simpler generally, as well as particularly as regards CSR-type information.

6.24 The annual business review (ABR)

We looked briefly at the ABR in Chapter 1, and again in Chapter 3 in the context of directors' obligations. Here we will look in more depth at the ABR element of the directors' report under section 417 of the Act. Section 417 of the Companies Act 2006 came into force on 1 October 2007 for reports for financial years beginning on or after that date.

All companies, other than small companies, must produce a business review as an element of their directors' report, as required by the EU Accounts Modernisation Directive (2003/51/EEC). This requirement is contained in section 417 of the Act, Act) which came into force on 1 October 2007 for reports for financial years beginning on or after 1 October 2007.

For reports for financial years beginning before 1 October 2007, the business review requirements of section 234ZZB of the Companies Act 1985.

If a company is entitled to the small companies' exemption in relation to the directors' report, its directors' report does not need to contain a business review (section 417(1)).

Where the directors' report is a group report, all references in section 417 of the Companies Act 2996 to the 'company' are to be read as references to the company and its consolidated subsidiary undertakings (section 417(9)). This means that all individual companies in a group, except small companies, must produce an ABR review as part of their directors' report.

Under the Act, the ABR has a statutory purpose, which is to inform the members of the company and help them assess how the directors have performed their duty under section 172 (duty to promote the success of the company) (section 417(2)). This is helpful in clarifying the intended addressees of the ABR – and therefore reducing the risk of other stakeholders claiming that it is deficient in areas of concern to them.

Directors should keep adequate records in relation to the preparation of the ABR, in case evidence is required as to how the review was compiled and to demonstrate that the directors have discharged their duty to promote the success of the company (see Enforcement). Directors should also take care not to create potential exposure when making the statements contained in the business review available to third parties for purposes other than annual reporting.

When any company (quoted or unquoted) is required to prepare an ABR, it must include the content specified in sections 417(3), (4), (6) and (8) and it may be possible to omit certain content in accordance with section 417(10). For quoted companies, there are additional content requirements.

The ABR must contain a fair review of the company's business, and a description of the principal risks and uncertainties facing the company (section 417(3)). It must be a balanced and comprehensive analysis of both the development and performance of the company's business during the financial year, and the position of the company's business at the end of that year, consistent with the size and complexity of the business (section 417(4)).

There is no formal guidance on what amounts to 'fair review' of the business, and there is a degree of overlap between the fair review requirement and the requirement to prepare a 'balanced and comprehensive analysis'.

As the requirement in section 417(3) is for a description of 'principal' risks and uncertainties, companies should consider what these actually are, and not just list all possible risks and uncertainties that they may face.

In meeting the requirement in section 417(4) for a 'balanced and comprehensive analysis', companies should assess the prominence given to the reporting of any negative matters, where appropriate.

To the extent necessary for an understanding of the development, performance or position of the company's business, the ABR must include analysis using financial key performance indicators (KPIs), and where appropriate, analysis using other KPIs, including information relating to environmental matters and employee matters (section 417(6)).

KPIs are factors by reference to which the development, performance or position of the company's business can be measured effectively. There are no statutory requirements on how KPIs should be presented and no requirements to produce explanatory information with KPIs, but the Accounting Standard Board's (ASB) Reporting Statement: Operating and Financial Review (January 2006) provides some useful guidance on KPIs. It recommends that a company should provide information that enables members to understand each KPI disclosed, including an explanation of:

- The definition and its calculation method;
- Its purpose;
- The source of the underlying data, and where relevant, the assumptions;
- Quantification or commentary on future targets;
- A reconciliation where information from the financial statements has been adjusted for inclusion;
- The corresponding amount for the previous financial year;
- Any changes to KPIs and the calculation method used compared to previous financial years, including significant changes in the underlying accounting policies adopted in the financial statements.

In practice, commonly used financial KPIs include things such as:

- earnings per share;
- cash flow;
- operating profit;

- total shareholder return; and
- return on capital employed.

and commonly used non-financial KPIs include employee or customer satisfaction, carbon emissions, health and safety commitments and community involvement.

Where appropriate, the ABR must include references to, and additional explanations of, amounts included in the company's annual accounts (section 417(8)), The directors may omit information about impending developments or matters in the course of negotiation where, in their opinion, disclosure would be seriously prejudicial to the interests of the company (section 417(10)).

Companies which are subject to the FSA's Transparency Rules should bear in mind that their directors are required by those rules to give responsibility statements that their financial statements give a true and fair view of the assets, liabilities, financial position and profit or loss of the company and any subsidiaries, and that the management report includes a fair review of the development and performance of the business (DTR 4.1.12R). It may be difficult for such companies to make use of the permitted omission in section 417(10) if this conflicts with the true and fair view requirements of the Transparency Rules.

Quoted companies (that is, those companies admitted to the Official List under FSMA or officially listed in an EEA state or admitted to dealing on the NYSE, Euronext or NASDAQ (section 385(2)) must provide additional disclosures in their ABRs (section 417(5)). They must, to the extent necessary for an understanding of the development, performance or position of the company's business, include:

- The main trends and factors likely to affect the future development, performance and position of the company's business (section 417(5)(a));
- Information about environmental matters (including the impact of the company's business on the environment), the company's employees, and social and community issues including information about any policies of the company in relation to those matters and the effectiveness of those policies (section 417(5)(b));

- Information about persons with whom the company has contractual or other arrangements which are essential to the business of the company (section 417(5)(c)) – this is subject to the proviso in section 417(11) that information need not be disclosed about a person if the disclosure would, in the opinion of the directors, be seriously prejudicial to that person and contrary to the public interest.

Where directors of quoted companies have nothing to report on environmental, employee, social and community matters and information about persons with whom they have contracts, their ABR review must say so (section 417(5)).

Quoted companies are required to have a forward looking element to their ABRs, whereas the ABRs of unquoted companies look back over the past year. Directors' fears associated with making forward-looking disclosures have to some extent been addressed by the safe harbour provisions in section 463 (see Untrue or misleading statements or omissions), but the new requirements to include information covered by section 417(5)(a) will inevitably result in the inclusion of forward-looking statements which are inherently uncertain and difficult to verify and directors should still include cautionary language to qualify the degree of reliance that shareholders should place on these statements, for example, to the effect that the forward-looking statements reflect knowledge and information at the time and that future events can cause results and developments to differ materially from those anticipated.

For companies with securities admitted to trading on a regulated market, the Transparency Rules include additional requirements for the publication of financial information giving a fair review of the company's business and describing the principal risks and uncertainties that the company.

The company auditors must state in their auditors' report on the company's annual accounts, whether the information in the directors' report, including the ABR, is consistent with the accounts (section 235(3), 1985 Act and section 496 (from 6 April 2008)).

Section B of International Standard on Auditing 720 (ISA 720) provides guidance for auditors on their statutory reporting responsibility in relation to directors' reports. ISA 720 is effective for audits of financial statements for periods beginning on or after 1 April 2005 and ending on or after 31 March 2006. It makes clear that 'information given in the directors' report' includes information by way of cross reference to other information presented separately from the directors' report (see Cross-referencing).

Under ISA 720, the auditor is not required to verify, or report on, the completeness of the information in the directors' report, but if the auditor becomes aware that legally required information has been omitted, the auditor must communicate the matter to those charged with governance (for example, the audit committee). This includes situations where the required information is presented separately from the directors' report without appropriate cross references.

Generally, the ABR will be included in the directors' report itself. However, if this is not the case, it is possible to incorporate it by cross reference.

In relation to requirements under the Companies Act 1985, the Government has stated that narrative reporting outside the directors' report, which is incorporated by cross-referencing within the directors' report, will satisfy the requirements as to location of the ABR (see Guidance on the changes to the Directors' Report requirements in the Companies Act 1985: April and December 2005, Department of Trade and Industry, February 2006). Such cross-references must clearly indicate which specific sections are relevant by way of page numbers, paragraph numbers or headings.

The Government has also said that there is to be no statutory reporting standard for the ABR. This means that directors, particularly directors of quoted companies, may wish to look to the Accounting Standards Board's voluntary Reporting Statement: 'Operating and Financial Review' for guidance. The recommendations of the Reporting Statement are more specific and more demanding than the business review requirements of the Companies Act 1985, and in some cases the Companies Act 2006.

6.25 Untrue or misleading statements or omissions

Under section 463 of the Companies Act 2006, a director is liable to compensate the company for any loss it suffers as a result of any untrue or misleading statement in, or omission from, the directors' report (or directors' remuneration report or a summary financial statement, only if he knew or was reckless as to whether the statement was untrue or misleading – or knew the omission to be dishonest concealment of a material fact. Section 463 applies to the ABR element of the directors' report, and may be welcomed by directors of quoted companies as it offers them some comfort in the disclosure of forward-looking information, as required by section 417(5)(a).

Under section 463(4), the directors' liability in respect of these reports is limited to the company only (and not to shareholders or third parties).

Section 463 has been effective since 20 January 2007. It applies to directors' reports, directors' remuneration reports and summary financial statements first sent to members on or after 20 January 2007. It does not apply to a directors' report, directors' remuneration report or summary financial statement sent to members and others under section 238 or 251 of the 1985 Act, before 20 January 2007. Therefore, whether a director is liable under section 463 will depend on when the relevant documents was sent to members, rather than the financial year to which they apply.

In addition to the safe harbour in section 463, section 234 offers directors protection in allowing (but not requiring) companies to indemnify directors in respect of proceedings brought by third parties and to pay directors' defence costs as they are incurred. Companies may address such indemnification by way of a qualifying third party indemnity provision.

In certain circumstance, issuers with securities traded on a UK regulated market, are liable to pay compensation to a person who has acquired securities and suffered loss as a result of any untrue or misleading statement in, or omission from, among

other reports, the directors' report (section 90A, Financial Services and Markets Act 2000). An issuer is only liable if:

- A person discharging managerial responsibilities for the report knew that the statement was wrong or misleading, was reckless as to whether it was, or knew the omission was a dishonest concealment of a material fact and
- The investor acquired securities in reliance on the information and at a time when, and in circumstances in which, it was reasonable for him to rely on that information.

The issuer will only be liable to third parties although the directors concerned may be liable to the issuer (section 90A(5), Financial Services and Markets Act 2000).

6.26 The Climate Change Act: greenhouse gas emissions

The new Climate Change Act 2008 deals with reporting of greenhouse gas emissions and became law on 26 November 2008. Section 83 of it provides that the Secretary of State must, by no later than 1 October 2009, publish guidance on the measurement or calculation of greenhouse gas emissions, to assist the reporting by persons on emissions from activities for which they are responsible. Section 85 obliges the Secretary of State, by not later than 6 April 2012, to make regulations under section 416(4) of the Companies Act 2006 requiring directors' reports to report on certain specified information about emissions of greenhouse gases for which the company is responsible. The Government has stated that it will consult publicly in 2009 on the detail of how companies' carbon emissions should be defined and measured.

Directors' Remuneration

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7.1 Remuneration committees

In this chapter, we will consider the role of remuneration committees, and the activities of non-executive directors in this regard.

Under UK law, directors are strictly not entitled to any remuneration unless their company's constitution expressly permits. Modern articles of association of listed companies will usually provide the maximum for directors' fees which can only be altered by ordinary resolution of shareholders. The board will however normally be empowered to determine the remuneration of directors as executives under their service contracts.

It is now common practice for listed companies to have separate remuneration committees. The Higgs review found that at that time, all except two of the companies in the FTSE 350 had a remuneration committee, as did 85% of companies outside the FTSE 350.

The objective of the remuneration committee is to ensure that companies have a formal process of considering directors' remuneration. As a rule, executive directors should play no part in decisions on their own remuneration, there should be an alignment of the remuneration schemes and the performance objectives of the company, and the remuneration schemes should attract and retain talented individuals. To be effective, any remuneration committee should be properly constituted with a clear remit and identified authority.

7.2 The Combined Code and remuneration

The Combined Code (the Code) sets out recommended practice and procedures in relation to directors' remuneration and the remuneration committee. It makes a number of detailed statements concerning the level and make-up of directors' remuneration and the procedure for determining an individual director's remuneration.

Compliance with the Code is not mandatory; the Listing Rules require a listed company (incorporated in the United Kingdom)

to make a disclosure statement on corporate governance and the Code in its annual report and accounts. This is the so called 'comply or explain' approach whereby listed companies, are required to provide, in their annual report and accounts, a statement of how they have applied the Main Principles of the Code, and a statement as to whether or not they have complied throughout the accounting period with the Code Provisions and to explain and justify any non-compliance. For reporting periods beginning on or after 29 June 2008, where applicable, issuers are also required to make corporate statements in accordance with DTR 7 of the Disclosure and Transparency Rules.

Adherence to the Code is however, regarded as best practice. In the Guidance on the Role of the Non-executive Director in the Good Practice Suggestions from the Higgs Report, it is stated that an effective non-executive director promotes the highest standards of corporate governance and seeks compliance with the provisions of the Code wherever possible. It is also stated that non-executive directors are responsible for determining appropriate levels of remuneration of executive directors.

7.3 Composition of the remuneration committee

The members of the remuneration committee are usually appointed by the board on the recommendation of the nomination committee in consultation with the chairman of the remuneration committee.

In its model terms of reference for remuneration committees, the Institute of Chartered Secretaries and Administrators recommends that appointments to the committee should be for a period of up to three years, which may be extended for two further three-year periods, provided the director still meets the criteria for membership of the committee (paragraph 1.3, ICSA guidance note, Terms of reference – remuneration committee, October 2007).

The Combined Code provides that remuneration committees should be made up of at least three members, all of whom are

independent non-executive directors (two, in the case of smaller companies) (Code Provision B.2.1). This provision was introduced as a result of the Higgs review. A smaller company is one that is below the FTSE 350 throughout the year immediately prior to the reporting year. The Institute of Chartered Secretaries and Administrators (ICSA) recommends that larger companies may wish to increase the number of members of the committee beyond three.

Code Provision B.2.1 also provides that 'In addition the company chairman may also be a member of, but not chair, the committee if he or she was considered independent on appointment as chairman.'

7.4 Chairmanship of the remuneration committee

The chairman of the committee should be an independent non-executive director. As noted above, Code Provision B.2.1 allows the chairman to sit on (but not chair) the remuneration committee where he is considered independent at the time of appointment as chairman. The chairman is in addition to the recommended minimum number of independent directors (three for FTSE 350 companies, two for others).

7.5 Meetings of the remuneration committee

There is no fixed number of meetings recommended in the Code, and the frequency with which the committee needs to meet will vary considerably from company to company and depend on the remit of the committee as set out in its terms of reference.

It is clear, however, that the remuneration committee must meet at least once each year prior or close to the year-end, to prepare and review the remuneration report which must be submitted to shareholders with or as part of the company's annual report, and put to the shareholders for approval at the AGM. The guidance note issued by ICSA recommends that the committee meets at least twice a year in order to discharge its

responsibilities properly (paragraph 4.1, ICSA guidance note, Terms of reference – remuneration committee, October 2007).

On average, remuneration committees generally meet three times a year, usually before main board meetings.

Meetings should, of course, be organised so that attendance is maximised – for example, by timetabling them to coincide with meetings of the full board.

7.6 Attendance

No one other than the committee chairman and members is entitled to be present at a meeting of the committee but others may attend at the invitation of the committee (Supporting Principle A.3, the Code).

The Higgs review found that the independence of members of the remuneration committee from executive management is necessary in view of the potential for conflicts of interest. But that is not to say that the chairman and chief executive may not attend committee meetings when invited to do so – indeed, it is likely that the remuneration committee would value their views. The director of human resources and external advisers may also be invited to attend all or part of committee meetings as and when appropriate.

Although it is not a provision in the Code, the Higgs review in its Non-Code Recommendations stated that as a matter of good practice, the company secretary (or their nominee) should act as secretary to the committee. (This is also a recommendation of ICSA guidance.) As we saw in Chapter 5, it is the company secretary's responsibility to ensure that the board and its committees are properly constituted and advised.

7.7 Records

Minutes should be taken of all meetings of the remuneration committee and circulated to the main board for information, unless a conflict of interest exists. Detailed attendance records should be kept in order to comply with the disclosure

requirements in the annual report. Such records may also be of use to the main board in reviewing the effectiveness and contribution of individual members of the committee (as is required under the performance evaluation provisions in the Code (Main Principle A.6, the Code)).

7.8 Relationship with the nomination committee

The remuneration committee needs to work closely with the nomination committee to ensure that incentives are appropriately structured for directors and for senior executives and any termination terms are carefully considered. The broad's aim is to avoid rewarding poor performance (Code Provision B.1.5).

7.9 Duties of the remuneration committee

The remuneration committee should have the delegated responsibility of setting remuneration for all executives and the chairman, and for recommending the level of remuneration for senior management (Code Provision B.2.2). In time, it seems a likely progression that remuneration committees will become the forum for reviewing and setting performance criteria as well as reviewing the rewards for key executive directors.

Annex E of the Higgs review contained a summary of the principal duties of remuneration committees. Some companies may wish to add to the duties contained in the summary, whilst smaller companies may wish to modify the duties as appropriate.

7.10 Terms of reference of the remuneration committee

In order to operate effectively, the committee needs to have clear terms of reference. It needs to be able to seek independent external advice where appropriate, for example, to establish

market position or to obtain information on specific types or aspects of executive remuneration; and to have an appropriate budget to enable this to be done.

The Code requires the remuneration committee to make available its terms of reference, explaining its role and the authority delegated to it by the board (Code Provision B.2.1).

In October 2007, ICSA produced a guidance note on the terms of reference to support the summary of the principal duties of remuneration committees. This guidance note updates previous ICSA guidance on this subject and takes into account the text of the 2006 version of the Code. The guidance note proposes model terms of reference for the remuneration committee which have been put together on the basis of experience of senior company secretaries and best practice in the UK's top listed companies.

The terms of reference include a list of duties of the remuneration which differ in content slightly from those set out in the Good Practice Suggestions from the Higgs Report (see paragraph 8, ICSA guidance note, Terms of reference – remuneration committee, October 2007). For example, the duties in the terms of reference include a duty to review and note annually the remuneration trends across the company or group.

7.11 Disclosures in relation to the committee

In accordance with the Code, the FSA's Disclosure and Transparency Rules and best practice, the remuneration committee should disclose certain information about itself and its work, including the following:

- The annual report should identify the chairman and members of the remuneration committee. It should also set out the number of meetings of the board and the committee and individual attendance by directors (Code Provision A.1.2);
- The remuneration committee should make available its terms of reference, explaining its role and the authority

delegated to it by the board (see Terms of reference of the remuneration committee).

Where remuneration consultants are appointed, a statement should be made available of whether they have any connection with the company (Code Provision B.2.1). A footnote to this Code Provision provides that a company may meet this requirement by making the information available on request and by including the information on the company's website.

The chairman of the remuneration committee should attend the AGM and be prepared to respond to any questions which may be raised by shareholders on matters within the committee's area of responsibility (Code Provision D.2.3).

For reporting periods beginning on or after 29 June 2008, the Disclosure and Transparency Rules also include a requirement for an issuer (broadly, whose transferable securities are admitted to trading and which is a company within the meaning of section 1(1) of the Companies Act 2006) to provide a corporate governance statement in its directors' report (or in a separate report published with it annual report or on its website in accordance with DTR 7.2.9R) which sets out a description of the composition and operation of, among other committees, the issuer's remuneration committee (DTR 7.2.7R). Compliance with Code Provisions A.1.1, A.1.2, A.4.6, B.2.1 and C.3.3 will, in the FSA's view, satisfy this requirement (DTR 7.2.8G).

The remuneration committee chairman should report formally to the board on its proceedings after each meeting on all matters within its duties and responsibilities (paragraph 9.1, ICSA guidance note, Terms of reference – remuneration committee, October 2007).

The remuneration committee should produce an annual report of the company's remuneration policy and practices which will form part of the company's annual report and ensure each year that it is put to the shareholders for approval by the AGM (see paragraph 9.2, ICSA guidance note, Terms of reference – remuneration committee, October 2007).

7.12 Key aspects of remuneration policy

Remuneration policy should aim to establish a clear link between reward and performance. When formulating policy, effective consultation by companies with institutional investors is advisable. It is preferable for companies to ensure that an appropriate policy is in place and followed, rather than to risk controversy when remuneration outcomes are disclosed in the annual report.

The Code deals with this by requiring the following:

- Levels and make up of remuneration should be sufficient to attract, retain and motivate the directors of the quality required to run the company successfully, but companies should avoid paying more than is necessary for this purpose. A significant proportion of executive directors' remuneration should be structured so as to link rewards to corporate and individual performance (Main Principle B.1, the Code);
- The Code also provides that the remuneration committee should judge where to position their company in relation to others, but this should be done with caution so as to avoid an upward ratchet of remuneration levels with no corresponding increase in performance (Supporting Principle B.1, the Code). The upward ratchet effect can come about through indiscriminate use of survey data. Since few, if any, companies wish to be seen to be paying below the median rate for the job, those companies who are told by survey data that they are paying below the median are likely to increase pay. These pay increases themselves, however, will raise the median so that the process starts all over again. Companies therefore need to pick their data carefully, using data from comparable companies and jobs and making sure that there is a reasonable sample size. There is often some virtue in using more than one survey and averaging the results.

Other sources of information on pay include the annual accounts of other listed companies, although the information might no longer be current by the time it becomes available in this way. External consultants can also assist by providing an independent report on current practice.

Remuneration committees should be sensitive to pay and employment conditions elsewhere in the group, especially when determining annual salary increases (Supporting Principle B.1, the Code). In other words, increases for directors should not routinely run ahead of those for other employees.

In summary the Code Provisions on remuneration provide that:

- Performance-related elements of remuneration should form a significant proportion of the total remuneration package of executive directors, and should be designed to align their interests with those of the shareholders and give those directors incentives to perform well.
- The remuneration committee should follow the provisions in Schedule A of the Code in designing performance related remuneration (Code Provision B.1.1).
- Performance related benefits fall broadly into three types: annual bonuses (which may be paid in cash or shares and may or may not be subject to deferral), conventional executive share options and long-term incentive schemes of various types.

Executive share options should not be offered at a discount except in limited circumstances as permitted by the FSA's Listing Rules 9.4.4R and 9.4.5R (Code Provision B.1.2). Discounted options have not been common in recent years. Shareholder approval is required for a grant of discounted options over new issue shares. There is no prohibition of discounted options over existing shares supplied through a trust.

Certain information should be included in the remuneration report where a company releases an executive director to serve as a non-executive director elsewhere (Code Provision B.1.4).

7.13 Service contracts and notice periods

The Code provides that:

- Notice periods and service contracts should be no more than one year in duration. If it is necessary to offer longer

notice or contract periods to new directors recruited from outside, these should reduce to one year or less after the initial period (Code Provision B.1.6). So far, although notice periods do appear to be reducing, there is still some way to go before most companies reach the target in this Code Provision;

- Remuneration committees should carefully consider what compensation commitments they would be under in the event of early termination of a director's service contract. The reward of poor performance should be avoided and the committee should take a robust line on reducing compensation to reflect mitigation of loss by the director (Code Provision B.1.5).

7.14 Procedure for developing a remuneration policy

The Code provides the following in relation to remuneration procedure:

- There should be a formal and transparent procedure for developing policy on executive remuneration and for fixing the remuneration packages of individual directors. No director should be involved in deciding his own remuneration (Main Principle B.2, the Code);
- The Supporting Principles provide that remuneration committees should consult the chairman and/or the chief executive officer about their proposals for remuneration of other executive directors and should be responsible for appointing any consultants in respect of executive director remuneration. The chairman of the board should ensure that the company maintains contact as required with its principal shareholders about remuneration in the same way as for other matters.

The four Code Provisions in relation to procedure provide:

- The remuneration committee should make publicly available its terms of reference, explaining its role and the authority delegated to it by the board. Where remuneration consultants are employed a statement should be made

available as to whether they have any other connection with the company (Code Provision B.2.1). As noted above, under the Disclosure and Transparency Rules there is some overlap between Code Provision B.2.1 and the requirements of DTR for reporting periods beginning on or after 29 June 2008;

- The remuneration committee should set the level and structure of remuneration for all executive directors and the chairman, including pension rights and compensation payments. The committee should also recommend and monitor the level and structure of remuneration for senior management (Code Provision B.2.2). Note that the committee determines executive directors' remuneration on behalf of the board; it would be invidious for executive directors, other than the chief executive and possibly the personnel director, to participate in remuneration decisions affecting fellow executive directors.

The board, or where required by the articles of association, the shareholders, should determine the remuneration of the non-executive directors, including members of the remuneration committee. If it is permitted by the articles, this task may be delegated to a sub-committee which might include the chief executive officer (Code Provision B.2.3).

Shareholders should be invited to approve all new long-term incentive schemes and significant changes to existing schemes (Code Provision B.2.4).

Remuneration committees should also look at pay packages of executives below board level, for both compensation purposes, to maintain the differential, and to take account of the fact that new board members will probably be promoted from the sub-board ranks.

7.15 Remuneration of non-executive directors

The levels of remuneration for non-executive directors should reflect the time commitment and responsibilities of the role. Remuneration for non-executive directors in share options should be avoided (Code Provision B.1.3).

The Code here follows the Higgs review which recommended that this provision could be satisfied by the chairman and executive directors ensuring that the fees of a non-executive director are clearly built up from an annual fee, meeting attendance fees and any additional fee for the chairmanship of committees or the role as a senior independent non-executive director.

The Code now addresses the concern that large shareholdings could prejudice the independence of a non-executive director, as there is the risk of an undesirable focus on share price rather than the underlying company performance.

The Code goes on to provide that if, exceptionally, share options are granted, advance shareholder approval should be sought and any shares acquired through the exercise of options should be held for at least one year after the non-executive director leaves the board. The holding of share options could be relevant to the determination of a non-executive's independence (as set out in Code Provision A.3.1) (Code Provision B.1.3).

It is, of course, best practice that no director or manager should be involved in any decisions as to his own remuneration. Therefore, the members of the remuneration committee should not determine their own remuneration.

The Code provides that the board, or where required by the articles of association, the shareholders, should determine the remuneration of the non-executive directors, including members of the remuneration committee. If permitted by the articles, this task may be delegated to a sub-committee, which might include the chief executive officer (Code Provision B.2.3). In practice, the remuneration of non-executives is normally set by a sub-committee of the board consisting of the chairman (whose own terms and remuneration are normally different from those of non-executive directors) and the chief executive, and is based on information relating to comparable companies. This is reflected in the summary of the duties of the remuneration committee in the Code.

7.16 Disclosure of directors' remuneration

For listed companies, a number of disclosures are required in relation to directors' remuneration under the FSA's Listing Rules. In addition, for financial periods beginning on or after 6 April 2008, the provisions of the Companies Act 2006 on directors' remuneration and The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 apply.

7.17 Guidelines and views of institutional investors

The scope for remuneration committees to alter plans or policies without involving shareholders has narrowed in recent years. Institutional investor bodies have sought to influence corporate governance and directors' remuneration over the years through investment guidelines issued to their members. Such guidelines cover remuneration, incentive schemes, service contracts and notice periods. Published guidelines include:

- **The Institutional Shareholders' Committee (ISC) Statement of Principles**. The Responsibilities of Institutional Shareholders and Agents: Statement of Principles was first published on 21 October 2002; the latest version is dated June 2007. It is a voluntary code which aims to encourage institutional shareholders and investment managers to play a more active role as owners of listed companies. The ISC comprises four institutional investor bodies: the Association of British Insurers, the National Association of Pension Funds, the Association of Investment Trust Companies and the Investment Management Association. The associations represent a large proportion of the UK's institutional investors. The Statement of Principles sets out best practice for institutional investors and investment managers, who are expected to:
  - Maintain and publish statements of their policies in respect of active engagement with the companies in which they invest;
  - Monitor the performance of and maintain an appropriate dialogue with those companies;

- Intervene where necessary;
- Evaluate the impact of their policies and report back to clients/beneficial owners.

The ISC gives useful guidance as to each of the principles, including examples of matters it expects to see covered in each of the stages of the process.

- **The Hermes Principles**. ''The Hermes Principles: What shareholders expect of public companies – and what companies should expect of their investors'' was first published on 21 October 2002 by Hermes, an independent fund manager. Like the ISC's statement, Hermes' principles are voluntary. The underlying message of this set of principles is that Hermes will continue to invest in those companies that demonstrate a commitment to being run in the long-term interest of shareholders. The 10 principles are business-based. For example, Hermes expects companies to:
  - test all investment plans for their ability to deliver long-term shareholder value;
  - have systems to analyse which activities maximise shareholder value; and
  - minimise the long-term cost of capital.

In 2006, Hermes published its Corporate Governance Principals – these are based on the Statement on Global Corporate Governance Principles issued by the International Corporate Governance Network (ICGN) in 1999 and revised in 2005, and provide guidance on remuneration.

- **The NAPF Corporate Governance Policy and Voting Guidelines** (November 2007). Part 1 of section B of the guidelines, which relate to directors' remuneration, largely reinforce the Code provisions on remuneration and acknowledge that most investors and companies will look to the ABI guidelines in the first instance for more detailed guidance on remuneration practice. The guidelines reiterate the most serious breaches of remuneration etiquette which are likely to result in a vote against the remuneration report. Guidance is included on the need for remuneration committee advisers to be independent. The 2007 version of the guidelines also included, for the first time, principles to

guide investors on the remuneration policies they should expect to see in overseas companies.

- **Association of British Insurers (ABI) guidelines on executive remuneration.** On 3 December 2007, the ABI published its revised annual guidelines on executive remuneration (Executive Remuneration ABI Guidelines on Policies and Practices).
- **The ABI and the National Association of Pension Funds (NAPF) joint statement on best practice on executive contracts and severance**. On 18 February 2008, the ABI and NAPF published a joint statement on 'Best Practice on Executive Contracts and Severance' which set out guidance on contract terms, notice periods, severance payments, pensions, and arrangements for shareholder inspection of directors' contracts and side letters relating to severance terms and pension arrangements.
- **PIRC Limited's shareholder voting guidelines**. In March 2008, PIRC published the 12th edition of its shareholder voting guidelines which include detailed guidelines on directors' remuneration and remuneration policy.

7.18 Use of remuneration consultants

Owing to the complex nature of remuneration policy, it is common for remuneration committees to employ remuneration consultants to assist them. Employment of consultants is envisaged in both the summary of the principal duties of remuneration committees in the Good Practice Suggestions of the Higgs Report and the related ICSA guidance note.

Where remuneration consultants are to be employed, the remuneration committee should control the selection and terms of reference of the remuneration consultant exclusively, rather than the board itself.

7.19 Designing incentives

Designing incentive schemes (particularly long-term share-based incentive schemes) is potentially one of the most

difficult areas that the remuneration committee has to address.

There are a number of factors that it will need to take into account when determining the most appropriate form of long-term incentive arrangement to offer company's executive directors, including:

- The views of institutional shareholders. These views can change rapidly and vary between shareholders;
- HR objectives. What are the main objectives of the plan? Is it to truly incentivise executives, or is it more to act as a 'golden handcuff'?
- The company's strategy. It is important that the plan (particularly the performance conditions that will determine the extent to which awards vest) fits with the company's business strategy;
- Market pressures. A fine balance has to be struck between offering market competitive levels of incentives to executives and levels that are palatable to shareholders;
- Impact on profit and loss and dilution. Committees should consider the profit and loss impact of all share schemes. In addition, ensuring that the plan can be operated within normal institutional investor dilution limits is also important;
- Technical issues. Clearly it is vital that all the legal issues are addressed when the plan is implemented and, indeed, that the plan is operated in as a tax efficient way as possible (whilst obviously taking account of simplicity and the views of shareholders);
- Performance related remuneration. Schedule A to the Code sets out provisions on the design of performance related remuneration.

7.20 Points for caution

It is difficult to produce a definitive list of 'cardinal sins' that remuneration committees will want to avoid committing, largely due to the fact that different shareholders have very different views on some of these issues. However, the

following practices should probably be avoided by remuneration committees (or will require full explanation if they do exist):

- Notice periods of more than one year;
- The ability to re-test performance conditions if not satisfied in full at the expiry of the initial (typically three year) performance period;
- Transaction bonuses (particularly bonuses related to the acquisition, rather than disposal, of a business);
- The lack of any performance conditions applying to share-based incentives, or performance conditions that are considered particularly undemanding;
- Excessive awards;
- Lack of independent non-executive directors is a particular issue at present;
- Re-pricing of options (or any similar approach, such as cancellation and re-grant of options);
- The grant of discounted options;
- The grant of options (or other share-based incentives) to non-executive directors.

7.21 Assessing base salaries

When setting executive directors' base salaries, it is important that the remuneration committee has access to robust data on pay practices in relevant groups of companies. A typical approach would be for two groups of companies to be constituted. The first group would be sourced from the company's sector. The second group would be taken from the market more generally and would comprise companies of a similar market capitalisation and turnover.

The resulting data would be presented in a quartile analysis so as to allow the remuneration committee to determine

(i) how their executives' base salaries compare to these two groups, and
(ii) where on the scale (lower quartile to median to upper quartile) their executives' base salaries should be set.

Clearly, when setting base salaries, it is important that the fundamental remuneration policy that has been adopted by the committee is followed.

One other obvious point, it is always important that account is taken of the specific circumstances of the company and the specific role of the executive when comparing executive pay with the benchmark data. For example, it may be right and proper for one executive of a company to be paid below the median, with another paid above the median to take account of their differing roles and responsibilities.

Index

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Accounting periods, 136–7
Accounting standards, 136
Accounting Standards Board (ASB):
Review of Narrative Reporting by Listed Companies (2006), 154
Voluntary Reporting Statement on Operating and Financial Review (2006), 153–4
AIM companies, 28
Andersen, 37
Annual accounts, 134–6
access to accounting records, 137–8
accounting periods, 136–7
applicable accounting standards, 136
approval and signature, 138
delivery to the Registrar of Companies, 143–5
directors' liability, 139–40
electronic form, 142
late delivery, 145–7
laying of accounts, 140
non-statutory accounts, 147–8
publication of, 147
quoted companies, 135–6
resolution, 141
revision of defective accounts and reports, 148–50
right to demand copies of, 143
sending copies to members, 141–2
signature of accounts, 138–9
statutory accounts, 147
true and fair requirement, 138
unquoted companies, 135
See also Financial reporting
Annual business review (ABR), 6, 155–60
quoted companies, 158–60
untrue or misleading statements or omissions, 161–2
Annual general meetings (AGMs), 94–5
accounts at, 95, 140
quoted companies, 99–101
Appointment of directors, 87–9
Association of British Insurers (ABI), 25, 31–2, 125
Best Practice on Executive Contracts and Severance, 179
Guidelines on Executive Remuneration, 179
Guidelines on Responsible Investment Disclosure, 31–2
Responsible Investment Disclosure Guidelines, 125–6
Social, Environmental and Ethical (SEE) Guidelines, 125, 126
Association of Investment Companies (AIC), 43–4
Association of Mutual Insurers (AMI), 39–40
Audit committee, 117–21
external audit, 120
internal audit, 119
whistleblowing, 119
Auditors, 92–4
liability limitation agreements, 92–3
Authorised share capital, 96
Authority to allot, 95

Bank Accounts Directive (Miscellaneous Banks) Regulations (2008), 133
Berardino, Joseph, 36
BERR, *See* Department for Business, Enterprise and Regulatory Reform (BERR)
Board composition, 15
Board member responsibilities, 17
Board structure, 17
Board's responsibility, 107–8
Bush, George W., 37
Business review, 90–2
annual business review (ABR), 155–60
enhanced business review (EBR), 150–5

Cadbury report (1992), 9
Capital maintenance, 17
Carbon Disclosure Project, 127
Carlton, 28
Centrica, 36
Climate Change Act (2008), 162
Codes of governance, 5
Combined Code on Corporate Governance (1998), 9, 25, 33–40
remuneration and, 165–6
tailored versions of, 39–40
Companies Act (2006), 26–7, 49–59, 127
Amendment (Accounts and Reports) Regulations (2008), 133–4
appointment of directors, 87–9
background to, 59–64
business review, 90–2

Companies Act (2006) (*continued*)
deregulation, 94–7
derivative claims, 89–90
directors' duties, 80–6
electronic communications provisions, 73–5
financial assistance, 99
information rights, 67–8
liability limitation agreements, 92–3
reporting matters, *See* Financial reporting
share capital, 97–9
shareholder issues, 64–7
statutory liability regime, 76–8
Takeovers Directive interaction, 78–9
Transparency Directive interaction, 75–6
Companies Act (Unregistered Companies) Regulations (2007), 79
Companies (Disclosure of Address) Regulations (2008), 97
Companies (Late Filing Penalties) and Limited Liability Partnerships (Filing Periods and Late Filing Penalties) Regulations (2008), 134, 146
Companies (Registration) Regulations (2008), 97
Companies (Revision of Defective Accounts and Reports) Regulations (2008), 134, 148–9
Companies (Summary Financial Statement) Regulations (2008), 133
Company secretaries:
need for, 95, 115
role of, 115–17
'Comply or explain' approach, 166
Cooper, Stephen, 36
Corporate governance:
codes of governance, 5
definition, 5
rules, 8–9
trends, 9–22
Europe, 11–19
financial sector, 21–2
global corporate governance, 10–11
increasing focus on CSR, 20–1
United States, 19–20
Corporate manslaughter, 27
Corporate restructuring, 18
Corporate social responsibility (CSR), 6–8
components of, 8
external demand, 7–8
increasing focus on, 20–1
internal/commercial drivers, 8
investor group guidelines, 30–3
Cross-Border Mergers Directive (2005/56/EC), 18

Department for Business, Enterprise and Regulatory Reform (BERR), 14, 18–19, 63
Department for Environment, Food and Rural Affairs, 154
Deregulation, 94–7
Derivative claims, 89–90
Directive on Takeover Bids (2004/25/EC), 78–9
Directors, 80–9
addresses, 97
appointment of, 87–9
duties of, 80–6
liability, 139–40, 161
non-executive directors, 175–6
notice periods, 173–4
remuneration of, *See* Directors' remuneration
service contracts, 173–4
Directors' remuneration, 15–16, 130, 165, 172–3, 174–5
base salary assessment, 181–2
disclosure, 177
non-executive directors, 175–6
See also Remuneration committees
Disclosure:
by institutional investors, 17, 67
of turnover, 130
Disclosure and Transparency Rules (DTR), 28, 40, 41, 73–4, 119, 121, 142–3
Duncan, David, 36
Dynegy, 36

Electronic communications, 73–5
annual accounts, 142
Enhanced business review (EBR), 150–5
Enlightened shareholder value, 5–6

Enron, 9, 19, 34–8
European Action Plan on Company Law and Corporate Governance, 11–19
annual corporate governance statement, 12–13
board composition, 15
capital maintenance, 17
corporate restructuring and mobility, 18
directors' remuneration, 15–16
groups of companies and pyramids, 18
strengthening shareholder's rights, 13–14
European Corporate Governance Forum, 16
European Private Company, 18
Extractive Industries Transparency Initiative, 127

Fair value, 131, 132
Fastow, Andrew, 35
Financial assistance, 95, 99
Financial reporting, 128–34
obligation to keep accounting records, 128–9
regulations, 129–34
See also Annual accounts
Financial Reporting Council (FRC), 30, 33, 41, 106–7, 118–20
Complexity and Relevance in Corporate Reporting Review, 155
Financial Reporting Review Panel (FRRP), 154
Financial sector, 21–2
Financial Services and Markets Act 2000 (FSMA), 8–9, 76–7
Financial Services Authority (FSA), 40–1
Code of Market Conduct, 26
Disclosure Rules and Transparency Rules, 28, 40, 41, 73–4, 119, 121, 142–3
Listing Rules, 27, 40, 41
Prospectus Rules, 27, 40, 41
FORGE Guidance on Corporate Social Responsibility Management and Reporting for the Financial Services Sector, 127

Global corporate governance, 10–11
Green, Michael, 28
Greenbury report (1995), 9
Greenhouse gas emissions, 162
Groups of companies, 18
group accounts, 130, 132

Hampel report (1998), 9
Hermes Principles, 178
Higgs report (2003), 9, 29–30, 34, 44–5

Incentive scheme design, 179–80
Information rights, 67–8
Institute of Chartered Secretaries and Administrators (ICSA), 66, 115–16, 170
Institutional disclosure of voting, 67
Institutional Shareholders' Committee (ISC), Statement of Principles, 177–8
Insurance Accounts Directive (Miscellaneous Insurance Undertakings) Regulations (2008), 133
Internal controls, effectiveness of, 109
reviewing the effectiveness, 109–10
statement in the accounts, 110–11

Key performance indicators (KPIs), 157–8

Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations (2008), 129–31
Lay, Kenneth, 36
Liability limitation agreements, 92–3
Listing Rules, 27, 40, 41
London Stock Exchange, 42–3

McCreevy, Charlie, 17
Memorandum of association, 96–7

National Association of Pension Funds (NAPF), 25, 29, 32–3, 126–7
Best Practice on Executive Contracts and Severance, 179
Corporate Governance Policy and Voting Guidelines, 32–3, 127, 178–9
Non-financial reporting, 125–8
Non-statutory accounts, 147–8
Notice period, 65–6

Objects, 96
Office of Public Sector Information (OPSI), 64
Organisation for Economic Co-operation and Development (OECD), 10–11

Partnerships (Accounts) Regulations (2008), 133
Pensions and Investment Research Consultants (PIRC), 25, 33
  Governance Plus Rating Service, 33
  shareholder voting guidelines, 179
Performance monitoring, 114
Political donations, 130, 132
Prospectus Rules, 27, 40, 41
Proxies, 64–5
Pyramids, 18

Quoted companies:
  annual account, 135–6
  annual business review (ABR), 158–60
Quoted Companies Alliance (QCA), 28

Record keeping, 114–15
Redeemable shares, 99
Register of members, 66
Registrar of Companies, delivery of accounts to, 143–5
  late delivery, 145–7
Related parties, 131
Remuneration committees, 165
  attendance, 168
  base salary assessment, 181–2
  chairmanship, 167
  composition, 166–7
  disclosures in relation to, 170–1
  duties of, 169
  guidelines and views of institutional investors, 177–9
  meetings, 167–8
  points for caution, 180–1
  records, 168–9
  relationship with nomination committee, 169
  remuneration policy development procedure, 174–5
  terms of reference, 169–70
Remuneration consultants, 179
Remuneration policy, 172–3
  development of, 174–5
  non-executive directors, 175–6
Reporting, *See* Financial reporting; Non-financial reporting
Risks, 108–9
  anticipation of, 111–12
  prioritisation, 112

Sarbanes–Oxley Act, 19, 118
Share capital, 97–9
  re-denomination of, 98
  reduction of, 98
Share premium, 98
Shareholder activism, 28–9
Shareholder democracy, 17
Shareholder issues, 64–9
Shareholders' addresses, 96
Short notice, 65
Skilling, Jeffrey, 36
Small Companies and Groups (Accounts and Directors' Report) Regulations (2008), 131–4
Smith Report (2003), 30, 34, 45–6
Stakeholders, 5
Statutory accounts, 147
Statutory liability regime, 76–8

Takeovers Directive (2004/25/EC), 78–9
Transparency Directive (2007), 75–6
Transparency Rules, *See* Disclosure and Transparency Rules (DTR)
Turnbull guidance, 25, 34, 41–2, 106–7
  board's responsibility, 107–8
  company secretary role, 115–17
  effectiveness of internal control system, 109–11
  implementation, 111–14
  performance monitoring, 114
  record keeping, 114–15
  risks to be considered, 108–9

United States, 19–20

Walker, Sir David, 21
Watkins, Sherron, 36
Whistleblowing, 119
World Bank, 10
WorldCom, 9, 19, 34
Written resolutions, 65