



FINANCIAL REPORTING COUNCIL

GOOD PRACTICE SUGGESTIONS FROM THE HIGGS REPORT

JUNE 2006



FINANCIAL REPORTING COUNCIL

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SUGGESTIONS FOR GOOD PRACTICE FROM THE HIGGS REPORT

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GUIDANCE ON THE ROLE OF THE CHAIRMAN

The chairman is pivotal in creating the conditions for overall board and individual director effectiveness, both inside and outside the boardroom. Specifically, it is the responsibility of the chairman to:

- + run the board and set its agenda. The agenda should take full account of the issues and the concerns of all board members. Agendas should be forward looking and concentrate on strategic matters rather than formulaic approvals of proposals which can be the subject of appropriate delegated powers to management;
- + ensure that the members of the board receive accurate, timely and clear information, in particular about the company's performance, to enable the board to take sound decisions, monitor effectively and provide advice to promote the success of the company;
- + ensure effective communication with shareholders and ensure that the members of the board develop an understanding of the views of the major investors;
- + manage the board to ensure that sufficient time is allowed for discussion of complex or contentious issues, where appropriate arranging for informal meetings beforehand to enable thorough preparation for the board discussion. It is particularly important that non-executive directors have sufficient time to consider critical issues and are not faced with unrealistic deadlines for decision-making;
- + take the lead in providing a properly constructed induction programme for new directors that is comprehensive, formal and tailored, facilitated by the company secretary;
- + take the lead in identifying and meeting the development needs of individual directors, with the company secretary having a key role in facilitating provision. It is the responsibility of the chairman to address the development needs of the board as a whole with a view to enhancing its overall effectiveness as a team;
- + ensure that the performance of individuals and of the board as a whole and its committees is evaluated at least once a year; and
- + encourage active engagement by all the members of the board.

The effective chairman:

- + upholds the highest standards of integrity and probity;
- + sets the agenda, style and tone of board discussions to promote

- effective decision-making and constructive debate;
- + promotes effective relationships and open communication, both inside and outside the boardroom, between non-executive directors and executive team;
- + builds an effective and complementary board, initiating change and planning succession in board appointments, subject to board and shareholders' approval;
- + promotes the highest standards of corporate governance and seeks compliance with the provisions of the Code wherever possible;
- + ensures clear structure for and the effective running of board committees;
- + ensures effective implementation of board decisions;
- + establishes a close relationship of trust with the chief executive, providing support and advice while respecting executive responsibility; and
- + provides coherent leadership of the company, including representing the company and understanding the views of shareholders.

GUIDANCE ON THE ROLE OF THE NON-EXECUTIVE DIRECTOR

As members of the unitary board, all directors are required to:

- + Provide entrepreneurial leadership of the company within a framework of prudent and effective controls which enable risk to be assessed and managed;
- + Set the company's strategic aims, ensure that the necessary financial and human resources are in place for the company to meet its objectives, and review management performance; and
- + Set the company's values and standards and ensure that its obligations to its shareholders and others are understood and met.

In addition to these requirements for all directors, the role of the non-executive director has the following key elements:

- + **Strategy.** Non-executive directors should constructively challenge and help develop proposals on strategy.
- + **Performance.** Non-executive directors should scrutinise the performance of management in meeting agreed goals and objectives and monitor the reporting of performance.
- + **Risk.** Non-executive directors should satisfy themselves on the integrity of financial information and that financial controls and systems of risk management are robust and defensible.
- + **People.** Non-executive directors are responsible for determining appropriate levels of remuneration of executive directors, and have a prime role in appointing, and where necessary removing, executive directors and in succession planning.

Non-executive directors should constantly seek to establish and maintain confidence in the conduct of the company. They should be independent in judgement and have an enquiring mind. To be effective, non-executive directors need to build a recognition by executives of their contribution in order to promote openness and trust.

To be effective, non-executive directors need to be well-informed about the company and the external environment in which it operates, with a strong

¹ A smaller company is one that is below the FTSE 350 throughout the year immediately prior to the reporting year.

² Some companies require the remuneration committee to consider the packages of all executives at or above a specified level such as those reporting to a main board director whilst others require the committee to deal with all packages above a certain figure.

³ Remuneration committees should consider reviewing and agreeing a standard form of contract for their executive directors, and ensuring that new appointees are offered and accept terms within the previously agreed level.

command of issues relevant to the business. A non-executive director should insist on a comprehensive, formal and tailored induction. An effective induction need not be restricted to the boardroom, so consideration should be given to visiting sites and meeting senior and middle management. Once in post, an effective non-executive director should seek continually to develop and refresh their knowledge and skills to ensure that their contribution to the board remains informed and relevant.

Best practice dictates that an effective non-executive director will ensure that information is provided sufficiently in advance of meetings to enable thorough consideration of the issues facing the board. The non-executive should insist that information is sufficient, accurate, clear and timely.

An element of the role of the non-executive director is to understand the views of major investors both directly and through the chairman and the senior independent director.

The effective non-executive director:

- + upholds the highest ethical standards of integrity and probity;
- + supports executives in their leadership of the business while monitoring their conduct;
- + questions intelligently, debates constructively, challenges rigorously and decides dispassionately;
- + listens sensitively to the views of others, inside and outside the board;
- + gains the trust and respect of other board members; and
- + promotes the highest standards of corporate governance and seeks compliance with the provisions of the Code wherever possible.

SUMMARY OF THE PRINCIPAL DUTIES OF THE REMUNERATION COMMITTEE

The Code provides that the remuneration committee should consist exclusively of independent non-executive directors and should comprise at least three or, in the case of smaller companies¹, two such directors.

Duties

The committee should:

- + determine and agree with the board the framework or broad policy for the remuneration of the chief executive, the chairman of the company and such other members of the executive management as it is designated to consider². At a minimum, the committee should have delegated responsibility for setting remuneration for all executive directors, the chairman and, to maintain and assure their independence, the company secretary. The remuneration of non-executive directors shall be a matter for the chairman and executive members of the board. No director or manager should be involved in any decisions as to their own remuneration;
- + determine targets for any performance-related pay schemes operated by the company;
- + determine the policy for and scope of pension arrangements for each executive director;
- + ensure that contractual terms on termination, and any payments made, are fair to the individual and the company, that failure is not rewarded and that the duty to mitigate loss is fully recognised³;
- + within the terms of the agreed policy, determine the total individual remuneration package of each executive director including, where appropriate, bonuses, incentive payments and share options;
- + in determining such packages and arrangements, give due regard to the contents of the Code as well as the UK Listing Authority's Listing Rules and associated guidance;
- + be aware of and advise on any major changes in employee benefit structures throughout the company or group;

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² Some companies require the remuneration committee to consider the packages of all executives at or above a specified level such as those reporting to a main board director whilst others require the committee to deal with all packages above a certain figure.

³ Remuneration committees should consider reviewing and agreeing a standard form of contract for their executive directors, and ensuring that new appointees are offered and accept terms within the previously agreed level.

- + agree the policy for authorising claims for expenses from the chief executive and chairman;
- + ensure that provisions regarding disclosure of remuneration, including pensions, as set out in the Directors' Remuneration Report Regulations 2002 and the Code, are fulfilled;
- + be exclusively responsible for establishing the selection criteria, selecting, appointing and setting the terms of reference for any remuneration consultants who advise the committee;
- + report the frequency of, and attendance by members at, remuneration committee meetings in the annual reports; and
- + make available the committee's terms of reference. These should set out the committee's delegated responsibilities and be reviewed and, where necessary, updated annually.

This guidance has been compiled with the assistance of ICSA who have kindly agreed to produce updated guidance on their website www.icsa.org.uk in the future.

SUMMARY OF THE PRINCIPAL DUTIES OF THE NOMINATION COMMITTEE

There should be a nomination committee which should lead the process for board appointments and make recommendations to the board.

A majority of members of the committee should be independent non-executive directors. The chairman or an independent non-executive director should chair the committee, but the chairman should not chair the nomination committee when it is dealing with the appointment of a successor to the chairmanship.

Duties

The committee should:

- + be responsible for identifying and nominating for the approval of the board, candidates to fill board vacancies as and when they arise;
- + before making an appointment, evaluate the balance of skills, knowledge and experience on the board and, in the light of this evaluation, prepare a description of the role and capabilities required for a particular appointment;
- + review annually the time required from a non-executive director. Performance evaluation should be used to assess whether the non-executive director is spending enough time to fulfil their duties;
- + consider candidates from a wide range of backgrounds and look beyond the “usual suspects”;
- + give full consideration to succession planning in the course of its work, taking into account the challenges and opportunities facing the company and what skills and expertise are therefore needed on the board in the future;
- + regularly review the structure, size and composition (including the skills, knowledge and experience) of the board and make recommendations to the board with regard to any changes;
- + keep under review the leadership needs of the organisation, both executive and non-executive, with a view to ensuring the continued ability of the organisation to compete effectively in the marketplace;
- + make a statement in the annual report about its activities; the process used for appointments and explain if external advice or open advertising has not been used; the membership of the committee, number of committee meetings and attendance over the course of the year;

- + make available its terms of reference explaining clearly its role and the authority delegated to it by the board; and
- + ensure that on appointment to the board, non-executive directors receive a formal letter of appointment setting out clearly what is expected of them in terms of time commitment, committee service and involvement outside board meetings.

The committee should make recommendations to the board:

- + as regards plans for succession for both executive and non-executive directors;
- + as regards the re-appointment of any non-executive director at the conclusion of their specified term of office;
- + concerning the re-election by shareholders of any director under the retirement by rotation provisions in the company's articles of association;
- + concerning any matters relating to the continuation in office of any director at any time; and
- + concerning the appointment of any director to executive or other office other than to the positions of chairman and chief executive, the recommendation for which would be considered at a meeting of the board.

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PRE-APPOINTMENT DUE DILIGENCE CHECKLIST FOR NEW BOARD MEMBERS

Why?

Before accepting an appointment a prospective non-executive director should undertake their own thorough examination of the company to satisfy themselves that it is an organisation in which they can have faith and in which they will be well suited to working.

The following questions are not intended to be exhaustive, but are intended to be a helpful basis of the pre-appointment due diligence process that all non-executive directors should undertake.

Questions to ask

What is the company's current financial position and what has its financial track record been over the last three years?

What are the key dependencies (e.g. regulatory approvals, key licences, etc)?

What record does the company have on corporate governance issues?

If the company is not performing particularly well is there potential to turn it round and do I have the time, desire and capability to make a positive impact?

What are the exact nature and extent of the company's business activities?

Who are the current executive and non-executive directors, what is their background and their record and how long have they served on the board?

What is the size and structure of the board and board committees and what are the relationships between the chairman and the board, the chief executive and the management team?

Who owns the company i.e. who are the company's main shareholders and how has the profile changed over recent years? What is the company's attitude towards, and relationship with, its shareholders?

Is any material litigation presently being undertaken or threatened, either by the company or against it?

Is the company clear and specific about the qualities, knowledge, skills and experience that it needs to complement the existing board?

What insurance cover is available to directors and what is the company's policy on indemnifying directors?

Do I have the necessary knowledge, skills, experience and time to make a positive contribution to the board of this company?

How closely do I match the job specification and how well will I fulfil the board's expectations?

Is there anything about the nature and extent of the company's business activities that would cause me concern both in terms of risk and any personal ethical considerations?

Am I satisfied that the internal regulation of the company is sound and that I can operate effectively within its stated corporate governance framework?

Am I satisfied that the size, structure and make-up of the board will enable me to make an effective contribution?

Would accepting the non-executive directorship put me in a position of having a conflict of interest?

Sources of information

- + Company report and accounts, and/or any listing prospectus, for the recent years.
- + Analyst reports.
- + Press reports
- + Company web site
- + Any Corporate Social Responsibility or Environmental Report issued by the company.
- + Rating agency reports
- + Voting services reports

Published material is unlikely to reveal wrong-doing, however a lack of transparency may be a reason to proceed with caution.

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SAMPLE LETTER OF NON-EXECUTIVE DIRECTOR APPOINTMENT

On [date], upon the recommendation of the nomination committee, the board of [company] ('the Company') has appointed you as non-executive director. I am writing to set out the terms of your appointment. It is agreed that this is a contract for services and is not a contract of employment.

Appointment

Your appointment will be for an initial term of three years commencing on [date], unless otherwise terminated earlier by and at the discretion of either party upon [one month's] written notice. Continuation of your contract of appointment is contingent on satisfactory performance and re-election at forthcoming AGM's. Non-executive directors are typically expected to serve two three-year terms, although the board may invite you to serve an additional period.

Time commitment

Overall we anticipate a time commitment of [number] days per month after the induction phase. This will include attendance at [monthly] board meetings, the AGM, [one] annual board away day, and [at least one] site visit per year. In addition, you will be expected to devote appropriate preparation time ahead of each meeting.

By accepting this appointment, you have confirmed that you are able to allocate sufficient time to meet the expectations of your role. The agreement of the chairman should be sought before accepting additional commitments that might impact on the time you are able to devote to your role as a non-executive director of the company.

Role

Non-executive directors have the same general legal responsibilities to the company as any other director. The board as a whole is collectively responsible for the success of the company. The board:

- + Provides entrepreneurial leadership of the company within a framework of prudent and effective controls which enable risk to be assessed and managed;
- + Sets the company's strategic aims, ensures that the necessary financial and human resources are in place for the company to meet its objectives, and reviews management performance; and

- + Sets the company's values and standards and ensure that its obligations to its shareholders and others are understood and met.

All directors must take decisions objectively in the interests of the company.

In addition to these requirements of all directors, the role of the non-executive director has the following key elements:

- + **Strategy.** Non-executive directors should constructively challenge and help develop proposals on strategy;
- + **Performance.** Non-executive directors should scrutinise the performance of management in meeting agreed goals and objectives and monitor the reporting of performance;
- + **Risk.** Non-executive directors should satisfy themselves on the integrity of financial information and that financial controls and systems of risk management are robust and defensible; and
- + **People.** Non-executive directors are responsible for determining appropriate levels of remuneration of executive directors and have a prime role in appointing, and where necessary removing, executive directors and in succession planning.

Fees

You will be paid a fee of £[amount] gross per annum which will be paid monthly in arrears, [plus [number] ordinary shares of the company per annum, both of] which will be subject to an annual review by the board. The company will reimburse you for all reasonable and properly documented expenses you incur in performing the duties of your office.

Outside interests

It is accepted and acknowledged that you have business interests other than those of the company and have declared any conflicts that are apparent at present. In the event that you become aware of any potential conflicts of interest, these should be disclosed to the chairman and company secretary as soon as apparent.

[The board of the Company have determined you to be independent according to provision A.3.1 of the Code.]

Confidentiality

All information acquired during your appointment is confidential to the Company and should not be released, either during your appointment or following termination (by whatever means), to third parties without prior clearance from the chairman.

Your attention is also drawn to the requirements under both legislation and regulation as to the disclosure of price sensitive information. Consequently you should avoid making any statements that might risk a breach of these requirements without prior clearance from the chairman or company secretary.

Induction

Immediately after appointment, the Company will provide a comprehensive, formal and tailored induction. This will include the information pack recommended by the Institute of Chartered Secretaries and Administrators (ICSA), available at www.icsa.org.uk. We will also arrange for site visits and meetings with senior and middle management and the Company's auditors. We will also offer to major shareholders the opportunity to meet you.

Review process

The performance of individual directors and the whole board and its committees is evaluated annually. If, in the interim, there are any matters which cause you concern about your role you should discuss them with the chairman as soon as is appropriate.

Insurance

The Company has directors' and officers' liability insurance and it is intended to maintain such cover for the full term of your appointment. The current indemnity limit is £ [amount]; a copy of the policy document is attached.

Independent professional advice

Occasions may arise when you consider that you need professional advice in the furtherance of your duties as a director. Circumstances may occur when it will be appropriate for you to seek advice from independent advisors at the company's expense. A copy of the board's agreed procedure under which directors may obtain such independent advice is attached. The Company will reimburse the full cost of expenditure incurred in accordance with the attached policy.

Committees

This letter refers to your appointment as a non-executive director of the Company. In the event that you are also asked to serve on one or more of the board committees this will be covered in a separate communication setting out the committee(s)'s terms of reference, any specific responsibilities and any additional fees that may be involved.

This sample appointment letter has been compiled with the assistance of ICSA who have kindly agreed to produce updated guidance on their website www.icsa.org.uk in the future.

INDUCTION CHECKLIST

Guidance on Induction

Every company should develop its own comprehensive, formal induction programme that is tailored to the needs of the company and individual non-executive directors. The following guidelines might form the core of an induction programme.

As a general rule, a combination of selected written information together with presentations and activities such as meetings and site visits will help to give a new appointee a balanced and real-life overview of the company. Care should be taken not to overload the new director with too much information. The new non-executive director should be provided with a list of all the induction information that is being made available to them so that they may call up items if required before otherwise provided.

The induction process should:

1. Build an understanding of the **nature of the company, its business and the markets in which it operates**. For example, induction should cover:
 - + the company's products or services;
 - + group structure / subsidiaries /joint ventures;
 - + the company's constitution, board procedures and matters reserved for the board;
 - + summary details of the company's principal assets, liabilities, significant contracts and major competitors;
 - + the company's major risks and risk management strategy;
 - + key performance indicators; and
 - + regulatory constraints.

2. Build a link with the **company's people** including;
 - + meetings with senior management;
 - + visits to company sites other than the headquarters, to learn about production or services and meet employees in an informal setting. It is important, not only for the board to get to know the new non-executive director, but also for the non-executive director to build a profile with employees below board level; and
 - + participating in board strategy development. 'Awaydays' enable a new non-executive director to begin to build working relationships away from the formal setting of the boardroom.

3. Build an understanding of the **company's main relationships** including meeting with the auditors and developing a knowledge of in particular:
- + who are the major customers;
 - + who are the major suppliers; and
 - + who are the major shareholders and what is the shareholder relations policy – participation in meetings with shareholders can help give a first hand feel as well as letting shareholders know who the non-executive directors are.

The induction pack

On appointment, or during the weeks immediately following, a new non-executive director should be provided with certain basic information to help ensure their early effective contribution to the company. ICSA has produced, and undertaken to maintain, on their website www.icsa.org.uk a guidance note detailing a full list of such material.

PERFORMANCE EVALUATION GUIDANCE

Guidance on performance evaluation

The Code provides that the board should undertake a formal and rigorous annual evaluation of its own performance and that of its committees and individual directors. Individual evaluation should aim to show whether each director continues to contribute effectively and to demonstrate commitment to the role (including commitment of time for board and committee meetings and any other duties). The chairman should act on the results of the performance evaluation by recognising the strengths and addressing the weaknesses of the board and, where appropriate, proposing new members be appointed to the board or seeking the resignation of directors. The board should state in the annual report how such performance evaluation has been conducted.

It is the responsibility of the chairman to select an effective process and to act on its outcome. The use of an external third party to conduct the evaluation will bring objectivity to the process.

The non-executive directors, led by the senior independent director, should be responsible for performance evaluation of the chairman, taking into account the views of executive directors.

The evaluation process will be used constructively as a mechanism to improve board effectiveness, maximise strengths and tackle weaknesses. The results of board evaluation should be shared with the board as a whole while the results of individual assessments should remain confidential between the chairman and the non-executive director concerned.

The following are some of the questions that should be considered in a performance evaluation. They are, however, by no means definitive or exhaustive and companies will wish to tailor the questions to suit their own needs and circumstances.

The responses to these questions and others should enable boards to assess how they are performing and to identify how certain elements of their performance areas might be improved.

Performance evaluation of the board

- + How well has the board performed against any performance objectives that have been set?
- + What has been the board's contribution to the testing and development of strategy?

- + What has been the board's contribution to ensuring robust and effective risk management?
- + Is the composition of the board and its committees appropriate, with the right mix of knowledge and skills to maximise performance in the light of future strategy? Are inside and outside the board relationships working effectively?
- + How has the board responded to any problems or crises that have emerged and could or should these have been foreseen?
- + Are the matters specifically reserved for the board the right ones?
- + How well does the board communicate with the management team, company employees and others? How effectively does it use mechanisms such as the AGM and the annual report?
- + Is the board as a whole up to date with latest developments in the regulatory environment and the market?
- + How effective are the board's committees? [Specific questions on the performance of each committee should be included such as, for example, their role, their composition and their interaction with the board.]

The processes that help underpin the board's effectiveness should also be evaluated e.g.:

- + Is appropriate, timely information of the right length and quality provided to the board and is management responsive to requests for clarification or amplification? Does the board provide helpful feedback to management on its requirements?
- + Are sufficient board and committee meetings of appropriate length held to enable proper consideration of issues? Is time used effectively?
- + Are board procedures conducive to effective performance and flexible enough to deal with all eventualities?

In addition, there are some specific issues relating to the chairman which should be included as part of an evaluation of the board's performance e.g.:

- + Is the chairman demonstrating effective leadership of the board?
- + Are relationships and communications with shareholders well managed?
- + Are relationships and communications within the board constructive?
- + Are the processes for setting the agenda working? Do they enable board members to raise issues and concerns?

- + Is the company secretary being used appropriately and to maximum value?

Performance evaluation of the non-executive director

The chairman and other board members should consider the following issues and the individual concerned should also be asked to assess themselves. For each non-executive director:

- + How well prepared and informed are they for board meetings and is their meeting attendance satisfactory?
- + Do they demonstrate a willingness to devote time and effort to understand the company and its business and a readiness to participate in events outside the boardroom such as site visits?
- + What has been the quality and value of their contributions at board meetings?
- + What has been their contribution to development of strategy and to risk management?
- + How successfully have they brought their knowledge and experience to bear in the consideration of strategy?
- + How effectively have they probed to test information and assumptions? Where necessary, how resolute are they in maintaining their own views and resisting pressure from others?
- + How effectively and proactively have they followed up their areas of concern?
- + How effective and successful are their relationships with fellow board members, the company secretary and senior management? Does their performance and behaviour engender mutual trust and respect within the board?
- + How actively and successfully do they refresh their knowledge and skills and are they up to date with:
 - + the latest developments in areas such as corporate governance framework and financial reporting ?
 - + the industry and market conditions?
- + How well do they communicate with fellow board members, senior management and others, for example shareholders? Are they able to present their views convincingly yet diplomatically and do they listen and take on board the views of others?



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