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Corporate governance: an introduction

Examines the origins, aims and framework of corporate governance as it exists in the UK

Introduction

Good corporate governance is about effectively supervising the management of a company to uphold the company's integrity, achieve more open and rigorous procedures and ensure legal compliance. Ultimately it should also promote good relations with stakeholders, including shareholders and employees. Since the UK Corporate Governance Code was created, corporate governance has evolved to reflect changing stakeholder priorities. Most recently, concerns have been about executive pay and a lack of diversity on boards and in top leadership teams. Problems with sexual harassment and poor working practices in some large companies have also hit the headlines, highlighting the risks to organisations and their staff if workforce and people management issues don't receive sufficient attention.

This factsheet explores the purpose of corporate governance, the regulations that reinforce it, and best practice as specified by the Code. It also looks at the roles and responsibilities of the board members as well as the audit, remuneration and nomination sub-committees.

Explore our stance on corporate governance and transparent reporting along with actions for Government and recommendations for employers.

What is corporate governance?

Corporate governance is necessary for the effective, entrepreneurial and prudent management that can deliver the long-term success of an organisation.

Effective governance involves supervising the management of a company and managing risks so that business is done competently, with integrity and with due regard to the interests of all stakeholders. It embraces regulation, structure, good practice and board ability.

In the UK, the Companies Act 2006 is the overarching legislation which sets out the legal requirements for corporate decision making, and the consequences of getting it wrong.

The UK Corporate Governance Code (the Code) then sets out standard of good practice aims to achieve more open and rigorous procedures, and requires all companies with a premium listing of equity shares in the UK to report on their application of the Code in their annual report and accounts.

The Financial Reporting Council (FRC) monitors the Code and publishes an annual report on it's impact and implementation. The FRC requires listed companies to disclose how they have applied the principles and whether they have complied with the provisions – a ‘comply or explain’ approach.

The Code provides a guide to key components of effective board practice including:

- **Leadership**: every company should have an effective board which is collectively responsible for the long term success of the company.
- **Effectiveness**: the board should have the appropriate balance of skills, experience, independence and knowledge of the company to enable them to carry out their duties effectively.
- **Accountability**: the board should present a fair, balanced and understandable assessment of the company's position and prospects
- **Remuneration**: executive directors' remuneration should aim to promote the long term success of the company and performance related elements should be transparent.
- **Relations with shareholders**: there should be a dialogue with shareholders based on the mutual understanding of objectives.

Following an inquiry in 2016 into the governance of UK companies, and extensive consultation, the current Code was published in 2018. It includes significant changes to how boards measure and understand workforce issues, including a new requirement that boards demonstrate how the organisation is improving employee voice at board level. Organisations are now required to illustrate how they’re applying one or more of the below models:

- Giving a non-executive director responsibility over workforce issues
- Establishing a workforce director (so-called 'worker on the board')
- Establishing an employee advisory committee (or broader stakeholder committee).

The updated Code also includes:

- Mandatory requirements for the reporting of pay ratios between chief executives and workers, include justification of the difference in pay

- New requirements for directors of all large organisations to set out how they are acting in the interests of employees and shareholders.
- A new public register of listed companies that have faced significant shareholder opposition to executive pay packages.
- A new requirement that the Remuneration Committee review pay across the wider workforce, and illustrate how employees have been engaged throughout the process. They must also illustrate how internal and external measures are being used to measure the appropriateness of executive pay.

Corporate governance is important as it helps to foster cooperation internally and promote the image of the company to its stakeholders and the public. Since its introduction, the Code has contributed to an improved framework in the UK which encourages discussions internally, with stakeholders, and promotes ethical business practices. Our Hidden figures report looks at how organisations in the UK FTSE 100 are reporting on their people practices.

Listen to our podcast - Does corporate governance need fresh thinking? which discusses the current state of UK corporate governance and what HR professionals can do to create a better system for the future.

Bribery and fraud

The Bribery Act 2010 brought together various pieces of law relating to bribery. It introduced four offences, including the corporate offence, which occurs when an organisation fails to stop people operating on its behalf from being involved in bribery. Organisations, led by the directors, are recommended to:

- Name a person responsible for all anti-bribery actions.
- Promote anti-bribery culture.
- Have a clear anti-bribery policy.
- Develop clear financial controls for large financial transactions.
- Train staff on anti-bribery to enable the correct actions when issue arise.
- Ensure an effective whistleblowing system is in place.
- Make clear the gifts and hospitality protocol.
- Specific clauses relating to anti-bribery and fraud should be included in contracts where appropriate.
- Detailed risk assessments and evaluations should be undertaken to highlight issues and learn from issues that may have occurred.

Modern slavery and supply chain issues

The Modern Slavery Act 2015 introduced a new requirement for companies, including those carrying out charitable, educational or public functions, with an annual turnover worldwide of £36 million or more, supplying goods or services in the UK (estimated to amount to 12,000 organisations), to publish a yearly statement setting out what they have done (or not done) in the previous 12 months to prevent slavery and forced labour practices in their own businesses and supply chains.

The statement, signed by a board director, must be published prominently on the company's website as soon as possible, and no later than six months (according to Home Office guidance) after the organisation's financial year end. The Modern Slavery Registry carries over 7,000 statements from nearly 6,000 companies made under the UK legislation.

A government report on how well the Act is working is due out in 2019. The government intends to publish a list of non-compliant organisations after that date.

The CIPD's modern slavery statement is on our governance webpage.

Role and composition of the board

Directors have a responsibility to promote the success of the company and are individually responsible for their actions. There are civil consequences if a director breaches any of the duties. The duties are enforceable by:

- Damages or compensation for the loss suffered by the company.
- Restoration of company's property.
- An account of profits made by the director.
- Cancelling a contract, if the director failed to disclose their interest.

A failure by a director to declare their interest in an existing transaction or arrangement is an offence and may give rise to a fine.

Boards are encouraged to think collectively and work towards compliance with the Code. It says: 'Every company should be headed by an effective board which is collectively responsible for the success of the company. The board's role is to provide entrepreneurial leadership of the company within a framework of prudent and effective controls which enables risk to be assessed and managed.'

A key issue for boards is how they incorporate diverse backgrounds and perspectives into their decision making. Gender balance at board level is one such challenge which has been recognised by government and the Hampton Alexander review aims to achieve board representation of 33% women by 2020.

Public and voluntary sector boards

Boards of directors also exist in the public, charity, health and voluntary sectors. Though the aims of these organisations are very different from those of commercial companies they still require the same management and accountability in the form of robust corporate governance.

Public sector bodies, such as the Cabinet Office, have produced guidance and case studies on corporate governance issues for public sector boards and for people wishing to take up public appointments.

The boards of voluntary or charitable organisations play a similar role to those in the public and private sectors. The positions are often unpaid but that does not mean that they are not as important. The National Council for Voluntary Organisations has produced guidance and advice on trustee and governance issues.

Composition of the board

The size and complexity of the organisation will usually determine the size of the board. In a small company the board may consist of just the managing director (MD) and one other. In larger organisations it could comprise the chair, chief executive, executive directors (EDs) and non-executive directors (NEDs).

From October 2015, the Small Enterprise, Business and Employment Act 2015 dictates that a corporate entity may not be a director of a company. There will also be a minimum age of sixteen years. The Code recommends that companies below FTSE 350 should have at least two independent non-executive directors.

Role of the chair

The role of the chair is to lead and manage the board, to be responsible for setting the board's agenda and to ensure that meetings are conducted properly, order is kept, the agenda is followed, items are discussed and decisions made. The Code recommends that the chair should be responsible for the leadership of the board and for ensuring effectiveness in all aspects of its role.

The chair is appointed in accordance with the articles of the company. The chair has a crucial role in ensuring that the executive directors and non-executive directors work together with a common purpose, using their different skills and competences, and promoting openness and debate. The Cadbury Review likened the role of the chair to that of an orchestra conductor – striking a balance between focused discussion and general debate for the overall effectiveness of the board.

The Code recommends that the chair should be independent and a chief executive should not go on to be chair of the company.

Role of the directors

The executive directors (EDs) will run the company's business and will often be directors of functions such as finance, HR or operations. Much has been written on which functions should be represented at board level and it is for each organisation to decide the composition of its board. However, EDs with certain titles should be aware that they will need to have the required specialist knowledge to carry out those roles.

Non-executive directors (NEDs) have the same duty of care as EDs. So before taking up any director appointment, it's vital to undertake a personal 'due diligence' to understand the company and the expectations placed on NEDs.

Role of the committees

The board may decide to delegate some of its authority to committees. The committees usually established are:

- Audit committee.
- Nomination committee.
- Remuneration committee.
- Ad hoc/special committees for a specific task (for example, risk committees in the financial services, following the Walker Review).

Each committee will have terms of reference and will normally report back to the board at agreed intervals.

Audit committee

The governing principles for audit committees in the Code are based on the conclusions and recommendations of the Smith Report. The Code recommends that at least one member of the audit committee should have recent and relevant financial experience. The FRC's Guidance on Audit Committees gives more detail.

Nomination committee

The nomination committee undertakes the selection of all new board appointments. Once the recruitment and selection process is complete the committee will recommend new appointments to the board.

Remuneration committee

The remuneration committee sets the remuneration for the EDs and the board chair, and increasingly considers fair pay and pay reporting across the organisation. The Code recommends that only NEDs should sit on the committee and that the remit should include the monitoring of remuneration packages of senior managers who are not EDs - there's pressure on committees to address excessive executive pay. We're exploring the future of the remuneration committee.

Useful contacts and further reading

Contacts

Institute of Directors website - briefings on corporate governance (some briefings are available to IOD members only)

Acas – Bribery

GOV.UK – Modern slavery

Safer Jobs

Books and reports

CHARTERED INSTITUTE OF PERSONNEL AND DEVELOPMENT. (2016) *A duty to care? Evidence of the importance of organisational culture to effective governance and leadership*. London: CIPD.

SIMPSON, J. and TAYLOR, J.R. (2013) *Corporate governance, ethics and CSR*. London: Kogan Page

TRICKER, B. (2019) *Corporate governance: principles, policies and practices*. Oxford: OUP.

Visit the CIPD and Kogan Page Bookshop to see all our priced publications currently in print.

Journal articles

CLARK, E. (2017) Employment practices are a key plank of good corporate governance. *People Management* (online). 15 November.

OZANNE, S. (2018) Modern slavery act: why corporate accountability is set to rise. *People Management* (online). 17 October.

ROPER, J. (2019) Can HR measure up? *HR Magazine*. November. pp16-23. Reviewed in *In a Nutshell,* issue 93.

ROPER, J. (2020) Rethinking corporate governance after Covid-19. *People Management* (online). 4 June.

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This factsheet was last updated by Ben Wilmott.