Boards of Public Listed Companies in 2020: Broadening roles and greater responsibilities

Article by Dr Louise Gorman, Examiner Professional 1 Corporate Governance, January 2020.

Amid the significant corporate, economic and social change which has characterised the past decade, biennial revisions to the UK Corporate Governance Code, as well as developments in other relevant regulation and company legislation, have resulted in a broadening of the board's role and a conferring of greater responsibilities on its members. In contemporary public listed companies, management accountability extends to a range of stakeholders beyond the shareholder. Major investment institutions such as BlackRock Investment Management, take the view that sustainable performing, stakeholder-oriented firms may offer more resilient returns, during market downturns (BlackRock Investment Management, 2018). The long-term, sustainable success of the firm has come to take precedence over short-term returns to shareholders, requiring acute risk management by the board; enhanced financial transparency; and comprehensive disclosure of executive remuneration and related policy. Presently, a wealth of guidance on best practice in corporate governance is published by the Financial Reporting Council (the FRC) in the UK Corporate Governance Code (2018) (the Code) and various additional guidance notes such as the FRC's Guidance on Risk Management, Internal Control and Related Financial and Business Reporting (2014); Audit Committees (2016); and Board Effectiveness (2018).

Within the traditional agency theory framework, the board is responsible for ratifying management decisions and monitoring the implementation of decisions. Contemporary boards should ratify only those decisions which are within the interests of the company's long-term success and are expected to generate value for shareholders while preserving the interests of non-shareholder stakeholders. As monitors, directors must take action if management jeopardise the company's long-term success in the execution of such decisions. This may involve challenging managements' policies or ultimately, dismissal of management and recruitment of replacements. Independent directors serve a crucial role in this regard as they bring independent judgement to bear on issues of strategy, performance and resources. The Code guides that at least half the board, excluding the chair, should be independent and that all directors should be subject to annual re-election. Nonetheless, due to their superior firm-specific knowledge and experience, the contribution executives make to the board is important in order for responsible ratification of decisions and evaluation of management performance.

Board Leadership

The Code has enduringly recommended that there should be a clear division of responsibilities between the leadership of the board, by the chairman, and the executive leadership of the company's business by the CEO. This is consistent with the view that a CEO who is also the chairman is likely to wield excessive power over decision-making, possibly to the detriment of shareholders' welfare. The chair should be independent on appointment and should not remain in the post beyond nine years

from the date of their first appointment. Chairs of currently listed companies assume a great deal of responsibility. An effective chair facilitates constructive board relations and promotes effective contributions from all non-executive directors, ensuring that directors receive accurate, timely and clear information. To aid effective monitoring of management, the chair should hold meetings with the non-executive directors without the executive directors present.

Board Meetings

Board meetings provide the primary opportunity for non-executive directors to challenge executives on issues which may affect the firm's long-term success. They are also a key forum in which executive directors can communicate information to non-executive directors regarding the company's operations and performance. Meetings should involve a financial review, a risk review and approval of committee reports when appropriate. Appointments, dismissals and issues arising from performance appraisals should also be addressed. The required attendance by directors at board meetings is generally dictated in the constitution of the company. As board diversity increases, full attendance at regular board meetings may pose a challenge. Once permitted by the company's constitution, directors may hold board meetings by electronic means. However, for companies incorporated overseas, but availing of Irish tax residency status, it is important to note that tax residency rules require that management and control is exercised in Ireland. Accordingly, directors' physical presence at board meetings in the state is a key factor in determining where management and control is being exercised.

The Audit Committee

Disclosure is the main mechanism through which financial accountability may be exercised. The Code's guidance reflects the importance of a suitably independent and experienced audit committee in this regard. The FRC's Guidance on Audit Committees recommends that there should be at least three committee meetings during the year, coinciding with key dates within the financial reporting and audit cycle. Where there is an internal audit function, the audit committee should review and approve its role and mandate, and monitor and review the effectiveness of its work. The committee has primary responsibility for the appointment of the external auditor. It should assess the external auditor's independence and objectivity annually; approve the external auditor's remuneration; and monitor the level of fees that the company pays relative to the overall fee income of the audit firm. The committee is also responsible for approving non-audit services so as to ensure that the provision of such services does not impair the external auditor's independence. It should develop and recommend to the board the company's policy in relation to the provision of non-audit services by the auditor and keep the policy under review. Despite the detailed guidance offered by the FRC in this regard, Grant Thornton's (2019) Annual Corporate Governance Review of FTSE 350 companies reports that 9% have retained the same auditor for over 20 years. The committee's engagements with the external auditor should address any major issues that arose in the audit; a consideration of key accounting and audit judgements; and a review of errors identified during the audit and related management explanations.

Risk Management

Careful oversight of risk-taking, a key priority of the post-crisis era, is another fundamental responsibility of the board. The Code advises that the board should establish procedures to manage risk, oversee the internal control framework, and determine the nature and extent of the principal risks the company is willing to take in order to achieve its long-term strategic objectives. The FRC's Guidance on Risk Management, Internal Control and Related Financial and Business Reporting advises that the board should continually monitor and review the company's risk management system so as ensure the system is properly aligned with its strategic objectives and is being developed, applied and maintained appropriately. The Code delegates much of the responsibility for risk monitoring and review to the audit committee and does not specifically recommend the establishment of a risk committee. However in certain industries, the financial services industry in particular, a separate risk committee may be required; for example, Irish financial institutions must establish a risk committee under the Central Bank's Corporate Governance Requirements.

Remuneration

Remuneration policies must incentivise directors to bear a prudent level of risk and compensate them for their efforts. The remuneration committee provides a means of monitoring the suitability of directors' remuneration. The Code advises that remuneration committees consist of independent directors so as to promote objective judgement and discretion in the authorisation of executive remuneration. The committee's responsibilities include determining the policy for executive remuneration and setting remuneration for the chair, executive directors and senior management. In determining and monitoring remuneration arrangements, the committee should ensure risks are identified and mitigated, and establish that remuneration drives behaviour consistent with company purpose, values and strategy.

In addition to a fixed pay component, a performance linked element serves to incentivise directors to ensure the company is managed in a manner consistent with shareholders' interests. Bonus payments are a means of rewarding performance in the short-term; however, the potential for bonuses to encourage undue risk-taking by executives has led to the introduction of deferral or clawback mechanisms to ensure such payments serve to align the interests of executives with the long-term interests of the company and its shareholders. A further means of counteracting the incentivisation of short-term risk-taking is to establish a strong link between the remuneration, risk and audit committees. Stock-based rewards to executives who achieve defined performance criteria may align their interests with those of shareholders in the long-term. Incentives in this regard may be enhanced through the awarding of restricted shares. Investors in FTSE 250 firm, Weir Group plc, have recently welcomed the introduction of such a scheme due to its longer-term orientation relative to the scheme previously in place in the company.

Annual disclosures made regarding remuneration should provide the strategic rationale for executive directors' remuneration policies, structures, and the performance metrics used. The remuneration committee should explain how policies are applied and metrics employed. The choice of performance metric should be a considered one. Common accounting and financial performance metrics are generally short-term in nature and not sufficiently comprehensive. Total Shareholder Return (TSR) and Economic Value Added (EVA) are advocated as potentially comprehensive measures. Measurement of performance relative to an appropriate index or peer group, over a three to five year period, may

help to achieve context and yield more insight into the sustainability of performance. In practice, a range of measures tends to be used, particularly as the need to consider companies' non-financial performance increases, for instance, environmental and social performance is now widely acknowledged to impact a company's sustained success. The Second EU Shareholders' Rights Directive, yet to be implemented in Ireland, will require the annual remuneration report to be put to an advisory shareholder vote. Shareholders will have the right to vote on the remuneration policy at least once every four years, this vote may be advisory or binding.

Although the extent of responsibility conferred upon directors has increased over the years, the Code retains considerable flexibility. In contrast, the rules-based requirements set out under the Sarbanes-Oxley Act (2002) (SOX) make little distinction between small and large firms such that managers' ability to adapt their boards and financial control systems to suit company circumstances may be restricted. Nonetheless, the possibility remains that companies in the UK and Ireland view compliance with the Code as a box-ticking exercise. The ideal behind the Code is that boards will follow its guidelines since deviations may raise questions among investors, leading them to voice their concerns or sell their shares. In the US, it is the judiciary rather than investors which monitors and penalises firms' governance shortcomings with the result that boards are punished even in the case of minor compliance failures. Indeed, SOX places a significant compliance cost upon companies in terms of board recruitment, implementation of sophisticated internal controls and related consultancy fees. Moreover, the requirements external auditors must fulfil, and the potential legal liability they face, can result in higher audit fees. It is argued that the extent of such costs may prevent companies from going public, thereby reducing market liquidity and efficiency.

References

BlackRock Investment Management (2018). *Sustainable Investing: a 'why not' moment.* Global Insights, May 2018. Available from: https://www.blackrock.com/corporate/literature/whitepaper/bii-sustainable-investing-may-2018-international.pdf

Financial Reporting Council (2014). *Guidance on Risk Management, Internal Control and Related Financial and Business Reporting, September 2014.* Available from: https://www.frc.org.uk/getattachment/d672c107-b1fb-4051-84b0-f5b83a1b93f6/Guidance-on-Risk-Management-Internal-Control-and-Related-Reporting.pdf

Financial Reporting Council (2016). *Guidance on Audit Committees, April 2016*. Available from: https://www.frc.org.uk/getattachment/6b0ace1d-1d70-4678-9c41-0b44a62f0a0d/Guidance-on-Audit-Committees-April-2016.pdf

Financial Reporting Council (2018). *Guidance on Board Effectiveness, July 2018*. Available from: https://www.frc.org.uk/getattachment/61232f60-a338-471b-ba5a-bfed25219147/2018-Guidance-on-Board-Effectiveness-FINAL.PDF

Financial Reporting Council (2018). *The UK Corporate Governance Code, July 2018*. Available from: https://www.frc.org.uk/getattachment/88bd8c45-50ea-4841-95b0-d2f4f48069a2/2018-UK-Corporate-Governance-Code-FINAL.pdf

Grant Thornton (2019). *Annual Corporate Governance Review*. Available from: https://www.grantthornton.co.uk/insights/corporate-governance-review-2019-the-issue-of-trust/