

The Combined Code

comply or explain



This paper summarises the new Combined Code, with which public companies must “comply or explain” for financial years ending on or after 31 October 2004.

The aim of the Combined Code is to enhance board effectiveness and to improve investor confidence by raising standards of corporate governance.

Quick guide

1. The Combined Code is a description of best practice for the biggest companies to aspire to.
2. “comply or explain” means just that; not “comply or else” – institutions should avoid a box-ticking approach and take into account each company’s individual circumstances.
3. Greater disclosure is required: how companies comply or not with the code’s “provisions” and a statement on how they have implemented the new category of “supporting principles”.
4. Half of the board should be non-executives (or at least two for sub-FTSE350s).
5. The board should undertake a formal and rigorous evaluation of its own performance and that of its committees and individual directors, and state in the annual report how such performance evaluation has been conducted.
6. The remuneration committee should be comprised exclusively of non-executives.
7. Non-executive directors who serve longer than nine years should be subject to annual re-election to ensure continued independence.
8. A CEO should not go on to be Chairman of the same company, and no FTSE100 Chairman should chair another FTSE100 company.
9. The number of board and individual committee meetings and attendees should be recorded.
10. The first annual reports in which companies are required to report on their compliance with the Code are for financial years ending 31 October 2004.

Overview

The context

- First published 1998 (Hampel Report combining/improving two previous codes: Cadbury 1992 and Greenbury 1995).
- New Code published in July 2003 by the FRC¹, and adopted by the FSA/UKLA² in February 2004 to replace the old Code as appendix to the Listing Rules. The Code is not part of the Listing Rules and compliance is not mandatory. It is appended to the Listing Rules for convenience.
- It derives from a review of the role and effectiveness of non-executive directors by Derek Higgs and a review of audit committees by a group led by Sir Robert Smith.
- UK companies required to report on their compliance for years beginning on or after 1 November 2003 (e.g. a company with March year end *must* report for the 2005 year end, published in June/July 2005; however they are *encouraged* to report sooner – the 2004 report, published June/July 2004).

The structure and broad content

- Listing Rules require listed companies to make a disclosure statement in two parts, but in no prescribed form:
 1. How principles are applied.
 2. Whether the company is compliant.
- New Code retains this “comply or explain” approach which has been in operation for over 10 years.
- Code has been restructured using a three-tier approach: main principles, supporting principles, code provisions.
- Old Code required listed companies to make a disclosure on how they apply the “principles” of the Code. New Code will require “main” and “supporting” principles.
- The word “breach” has been deliberately avoided in favour of the phrase “departure from the Code”, recognising that there will be circumstances where it does not make sense for a company to comply with every aspect.
- The new Code does not include material in the previous Code on the disclosure of directors’ remuneration. “The Directors’ Remuneration Report Regulations 2002”³, requiring companies to prepare a remuneration report are now in force and supersede the earlier Code provisions.
- Shareholders should judge governance with common sense, not in a mechanistic way.

The key features

Non-executive directors

- Role and duties of non-executives are considerably reinforced, particularly with regard to scrutinising management and monitoring performance.
- Terms of appointment of non-executives should be available for inspection; appointment should be limited to a six to nine year term.
- At least half the board in larger listed companies to be independent non-executives.
- Determine the independence of each non-executive.
- Further details on the existing role of the senior non-executive, who should be available to shareholders if concerns raised with the Chairman, Chief Executive Officer and Financial Director have not been resolved.
- More open and rigorous procedures for the appointment of directors and from a wider pool of candidates.
- Closer relationships between the Chairman, the senior independent director, non-executive directors and major shareholders.

Chairman and Chief Executive Officer

- The separation of the roles of the Chairman and the Chief Executive Officer to be reinforced.
- A Chief Executive Officer should not go on to become Chairman of the same company.

Boards and committees

- New definitions of the role of the board, the Chairman and the non-executive directors.
- Formal evaluation of the performance of boards, committees and individual directors, enhanced induction and more professional development of non-executive directors.
- A strengthened role for the audit committee in monitoring the integrity of the company’s financial reporting, reinforcing the independence of the external auditor and reviewing the management of financial and other risks.
- Remuneration committees are cautioned against any upward ratchet of remuneration of directors without corresponding improvement in performance, and to be sensitive to pay and employment conditions within the company as a whole.

¹ Financial Reporting Council www.frc.org.uk

² Financial Services Authority’s Listing Rules (2002) www.fsa.gov.uk/pubs/ukla/

³ Published 25 July 2002: effective for company’s reporting on financial years ending on or after 31 December 2002.

Code of Best Practice

The items below should be disclosed in the annual report:

	Code provision	Typical presentation
Main board of directors		
How the board operates, including high level statement of which types of decisions are to be taken by the board and those delegated to the management	A.1.1	Text/table
The identity of the Chairman, the Deputy Chairman (where there is one), the Chief Executive Officer and the senior independent director	A.1.2	Text
Number of meetings	A.1.2	Table
Individual attendance	A.1.2	Table
Reasons why the Chief Executive Officer should become Chairman (where relevant)	A.2.2	Text
The names of the non-executive directors whom the board determines to be independent, with reasons where necessary	A.3.1	Text/table
Any other significant commitments of the Chairman and changes to these commitments as they arise during the year	A.4.3	Text
Whether performance evaluation of the board, its committees and its individual directors is taking place and how it is conducted	A.6.1	Text
An explanation from the directors of their responsibility for preparing the accounts plus a statement by the auditors about their reporting responsibilities	C.1.1	Text
A statement from the directors that the business is a going concern, with supporting assumptions or qualifications where necessary	C.1.2	Text
A report that the board has conducted a review of the effectiveness of the group's system of internal controls covering all risks (financial, operational and compliance controls and risk management), including process for its annual assessment and scope and frequency of the reports it receives from management and reviews during the year ⁴	C.2.1	Text
The efforts of the board to ensure that its members, especially the non-executive directors, develop an understanding of the views of major investors	D.1.2	Text
Remuneration committee		
Number of meetings	A.1.2	Table
Individual attendance	A.1.2	Table
The identity of the Chairman and members of the remuneration committee	A.1.2	Text
A description of the work of the committee as required under the Directors' Remuneration Report Regulations 2002, including, where an executive director serves as a non-executive director elsewhere, whether or not the director will retain such earnings and, if so, what the remuneration is	B.1.4	Text

cont.

⁴ As recommended by The Turnbull Guidance 1999, an appendix to the new Combined Code.

	Code provision	Typical presentation
Nomination committee		
Number of meetings	A.1.2	Table
Individual attendance	A.1.2	Table
The identity of the Chairman and members of the nomination committee	A.1.2	Text
Details of its activities and the process it has used to make appointments	A.4.6	Text
Where relevant, an explanation of why an external search consultancy or open advertising has not been used in making appointments of a Chairman or a non-executive director	A.4.6	Text
Audit committee		
Number of meetings	A.1.2	Table
Individual attendance	A.1.2	Table
The identity of the Chairman and members of the audit committee	A.1.2	Text
Action taken by the committee to fulfill its duties set out in its terms of reference	C.3.3	Text
Where there is no internal audit function, the reasons for the absence of this function	C.3.5	Text
Where the board does not accept the audit committee's recommendations on the appointment, reappointment or removal of external auditors, a statement explaining the recommendation and the reasons why the board has taken a different position	C.3.6	Text
Explanation of how, if the auditor provides non-audit services, auditor objectivity and independence is safeguarded	C.3.7	Text

The items below should be made available on request and on the company's website:

	Code provision
Main board of directors	
Terms and conditions of appointment of non-executive directors	A.4.4
Remuneration committee	
Terms of reference, explaining the role of the remuneration committee and the authority delegated to it by the board	B.2.1
Where remuneration consultants are appointed, a statement of whether they have any other connection with the company	B.2.1
Nomination committee	
Terms of reference, explaining the role of the nomination committee and the authority delegated to it by the board	A.4.1
Audit committee	
Terms of reference, explaining the role of the audit committee and the authority delegated to it by the board	C.3.3

Code of Best Practice continued

Requirements for the board and board committees:

	Code provision
Chairman	
The role of the Chairman and Chief Executive Officer should not be exercised by the same person	A.2.1
The Chief Executive Officer should not go on to be the Chairman of the same company	A.2.2
On appointment, the Chairman should be "independent"	A.2.2
Board	
Boards should not be so large as to become unwieldy	sp A.3
There should be strong executive and non-executive director representation on the board	sp A.3
At least half the board, excluding the Chairman, should comprise independent non-executive directors (sub FTSE350s should have at least two)	A.3.2
One of the independent non-executive directors should be appointed as the senior independent director	A.3.3
Any term beyond six years for a non-executive director should be subject to "particularly rigorous review"	A.7.2
Non-executive directors serving nine years or more should be subject to annual re-election	A.7.2
No individual should be Chairman of more than one FTSE100 company	A.4.3
A full-time executive director should not take on more than one non-executive directorship in a FTSE100 company	A.4.5
A full-time executive director should not become Chairman of more than one FTSE100 company	A.4.5
Nomination committee	
The nomination committee should consist of a majority of independent non-executive directors and its Chairman should be an independent non-executive director or the Chairman (except when dealing with the appointment of a successor to the chairmanship)	A.4.1
Remuneration committee	
The remuneration committee should have at least three members (at least two for sub-FTSE350s), who should all be independent non-executive directors	B.2.1
Audit committee	
The audit committee should have at least three members (at least two for sub-FTSE350s), who should all be independent non-executive directors. At least one member should have recent relevant financial experience	C.3.1
The Chairman of the company should not be a member of the audit committee	The Smith Guidance 2.4
Audit committee appointments should be for a period of up to three years which can be extended by no more than two additional three year periods so long as members continue to be independent	The Smith Guidance 2.6

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