Financial Reporting Council

Guidance on Board Effectiveness

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Preface

The Guidance on Board Effectiveness is one of a suite of guidance notes issued by the Financial Reporting Council (FRC) to assist companies in applying the principles of the UK Corporate Governance Code. It replaces 'Good Practice Suggestions from the Higgs Report' (known as "the Higgs Guidance"), which was last issued in 2006.

This guidance relates primarily to Sections A and B of the Code on the leadership and effectiveness of the board. As with the separate guidance notes on audit committees and internal control, the new guidance is not intended to be prescriptive. It does not set out "the right way" to apply the Code. Rather it is intended to stimulate boards' thinking on how they can carry out their role most effectively. Ultimately it is for individual boards to decide on the governance arrangements most appropriate to their circumstances, and interpret the Code and guidance accordingly.

The guidance does not seek to address all the issues covered in Sections A and B of the Code, but only those where consultation with companies, individual board members and investors suggested that further guidance might be helpful. Nor does it include all of the material contained in the Higgs Guidance, for example, draft letters of appointment and terms of reference for board committees. Helpful material on these issues is provided by a range of organisations, and some links are provided in the Appendix.

The UK Corporate Governance Code has evolved since it was first introduced in 1992. It has always placed great importance on clarity of roles and responsibilities, and on accountability and transparency. It has become increasingly clear in the intervening period that, while these are necessary for good governance, they are not sufficient on their own. Boards need to think deeply about the way in which they carry out their role and the behaviours that they display, not just about the structures and processes that they put in place.

This change of emphasis is reflected in the most recent edition of the UK Corporate Governance Code, published in 2010, and also in this guidance. For example, boards are encouraged to consider how the way in which decisions are taken might affect the quality of those decisions, and the factors to be taken into account when constructing the board and reviewing its performance. The FRC hopes that this guidance will assist in those considerations.

The FRC would like to express its gratitude to the Institute of Chartered Secretaries and Administrators and the Steering Group it established under the chairmanship of Sir John Egan for consulting on and developing this guidance on the FRC's behalf.

BARONESS HOGG
Chairman, Financial Reporting Council

One – The Role of the Board and Directors

An Effective Board

1.1. 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.

1.2. An effective board develops and promotes its collective vision of the company's purpose, its culture, its values and the behaviours it wishes to promote in conducting its business. In particular it:

- provides direction for management;
- demonstrates ethical leadership, displaying – and promoting throughout the company – behaviours consistent with the culture and values it has defined for the organisation;
- creates a performance culture that drives value creation without exposing the company to excessive risk of value destruction;
- makes well-informed and high-quality decisions based on a clear line of sight into the business;
- creates the right framework for helping directors meet their statutory duties under the Companies Act 2006, and/or other relevant statutory and regulatory regimes;
- is accountable, particularly to those that provide the company's capital; and
- thinks carefully about its governance arrangements and embraces evaluation of their effectiveness.

1.3. An effective board should not necessarily be a comfortable place. Challenge, as well as teamwork, is an essential feature. Diversity in board composition is an important driver of a board's effectiveness, creating a breadth of perspective among directors, and breaking down a tendency towards 'group think'.

The Role of the Chairman

1.4. Good boards are created by good chairmen. The chairman creates the conditions for overall board and individual director effectiveness.

1.5. The chairman should demonstrate the highest standards of integrity and probity, and set clear expectations concerning the company's culture, values and behaviours, and the style and tone of board discussions.

1.6. The chairman, with the help of the executive directors and the company secretary, sets the agenda for the board's deliberations.

1.7. The chairman's role includes:

- demonstrating ethical leadership;
- setting a board agenda which is primarily focused on strategy, performance, value creation and accountability, and ensuring that issues relevant to these areas are reserved for board decision;
- ensuring a timely flow of high-quality supporting information;
- making certain that the board determines the nature, and extent, of the significant risks the company is willing to embrace in the implementation of its strategy, and that there are no 'no go' areas which prevent directors from operating effective oversight in this area;
- regularly considering succession planning and the composition of the board;
- making certain that the board has effective decision-making processes and applies sufficient challenge to major proposals;
- ensuring the board's committees are properly structured with appropriate terms of reference;
- encouraging all board members to engage in board and committee meetings by drawing on their skills, experience, knowledge and, where appropriate, independence;
- fostering relationships founded on mutual respect and open communication – both in and outside the boardroom – between the non-executive directors and the executive team;
- developing productive working relationships with all executive directors, and the CEO in particular, providing support and advice while respecting executive responsibility;
- consulting the senior independent director on board matters in accordance with the Code;
- taking the lead on issues of director development, including through induction programmes for new directors and regular reviews with all directors;
- acting on the results of board evaluation;
- being aware of, and responding to, his or her own development needs, including people and other skills, especially when taking on the role for the first time; and
- ensuring effective communication with shareholders and other stakeholders and, in particular, that all directors are made aware of the views of those who provide the company's capital.

1.8. The chairman of each board committee fulfils an important leadership role similar to that of the chairman of the board, particularly in creating the conditions for overall committee and individual director effectiveness.

The Role of the Senior Independent Director

1.9. In normal times the senior independent director should act as a sounding board for the chairman, providing support for the chairman in the delivery of his or her objectives, and leading the evaluation of the chairman on behalf of the other directors, as set out in the Code. The senior independent director might also take responsibility for an orderly succession process for the chairman.

1.10. When the board is undergoing a period of stress, however, the senior independent director's role becomes critically important. He or she is expected to work with the chairman and other directors, and/or shareholders, to resolve significant issues. Boards should ensure they have a clear understanding of when the senior independent director might intervene in order to maintain board and company stability. Examples might include where:

- there is a dispute between the chairman and CEO;
- shareholders or non-executive directors have expressed concerns that are not being addressed by the chairman or CEO;
- the strategy being followed by the chairman and CEO is not supported by the entire board;
- the relationship between the chairman and CEO is particularly close, and decisions are being made without the approval of the full board; or
- succession planning is being ignored.

1.11. These issues should be considered when defining the role of the senior independent director, which should be set out in writing.

The Role of Executive Directors

1.12. Executive directors have the same duties as other members of a unitary board. These duties extend to the whole of the business, and not just that part of it covered by their individual executive roles. Nor should executive directors see themselves only as members of the CEO's executive team when engaged in board business. Taking the wider view can help achieve the advantage of a unitary system: greater knowledge, involvement and commitment at the point of decision. The chairman should make certain that executives are aware of their wider responsibilities when joining the board, and ensure they receive appropriate induction and regular training, to enable them to fulfil the role. Executive directors are also likely to be able to broaden their understanding of their board responsibilities if they take up a non-executive director position on another board.

1.13. The CEO is the most senior executive director on the board with responsibility for proposing strategy to the board, and for delivering the strategy as agreed. The CEO's relationship with the chairman is a key relationship that can help the board be more effective. The Code states that the differing responsibilities of the chairman and the CEO should be set out in writing and agreed by the board. Particular attention should be paid to areas of potential overlap.

1.14. The CEO has, with the support of the executive team, primary responsibility for setting an example to the company's employees, and communicating to them the expectations of the board in relation to the company's culture, values and behaviours. The CEO is responsible for supporting the chairman to make certain that appropriate standards of governance permeate through all parts of the organisation. The CEO will make certain that the board is made aware, when appropriate, of the views of employees on issues of relevance to the business.

1.15. The CEO will ensure the board knows the executive directors' views on business issues in order to improve the standard of discussion in the boardroom and, prior to final decision on an issue, explain in a balanced way any divergence of view in the executive team.

1.16. The CFO has a particular responsibility to deliver high-quality information to the board on the financial position of the company.

1.17. Executive directors have the most intimate knowledge of the company and its capabilities when developing and presenting proposals, and when exercising judgement, particularly on matters of strategy. They should appreciate that constructive challenge from non-executive directors is an essential aspect of good governance, and should encourage their non-executive colleagues to test their proposals in the light of the non-executives' wider experience outside the company. The chairman and the CEO should ensure that this process is properly followed.

The Role of Non-Executive Directors

1.18. A non-executive director should, on appointment, devote time to a comprehensive, formal and tailored induction which should extend beyond the boardroom. Initiatives such as partnering a non-executive director with an executive board member may speed up the process of him or her acquiring an understanding of the main areas of business activity, especially areas involving significant risk. The director should expect to visit, and talk with, senior and middle managers in these areas.

1.19. Non-executive directors should devote time to developing and refreshing their knowledge and skills, including those of communication, to ensure that they continue to make a positive contribution to the board. Being well-informed about the company, and having a strong command of the issues relevant to the business, will generate the respect of the other directors.

1.20. Non-executive directors need to make sufficient time available to discharge their responsibilities effectively. The letter of appointment should state the minimum time that the non-executive director will be required to spend on the company's business, and seek the individual's confirmation that he or she can devote that amount of time to the role, consistent with other commitments. The letter should also indicate the possibility of additional time commitment when the company is undergoing a period of particularly increased activity, such as an acquisition or takeover, or as a result of some major difficulty with one or more of its operations.

1.21. Non-executive directors have a responsibility to uphold high standards of integrity and probity. They should support the chairman and executive directors in instilling the appropriate culture, values and behaviours in the boardroom and beyond.

1.22. Non-executive directors should insist on receiving high-quality information sufficiently in advance so that there can be thorough consideration of the issues prior to, and informed debate and challenge at, board meetings. High-quality information is that which is appropriate for making decisions on the issue at hand – it should be accurate, clear, comprehensive, up-to-date and timely; contain a summary of the contents of any paper; and inform the director of what is expected of him or her on that issue.

1.23. Non-executive directors should take into account the views of shareholders and other stakeholders, because these views may provide different perspectives on the company and its performance.

Two – Board Support and the Role of the Company Secretary

2.1. The requirement for a company secretary of a public company is specified in section 271 of the Companies Act 2006. The obligations and responsibilities of the company secretary outlined in the Act, and also in the Code, necessitate him or her playing a leading role in the good governance of the company by supporting the chairman and helping the board and its committees to function efficiently.

2.2. The company secretary should report to the chairman on all board governance matters. This does not preclude the company secretary also reporting to the CEO in relation to his or her other executive management responsibilities. The appointment and removal of the company secretary should be a matter for the board as a whole, and the remuneration of the company secretary might be determined by the remuneration committee.

2.3. The company secretary should ensure the presentation of high-quality information to the board and its committees. The company secretary can also add value by fulfilling, or procuring the fulfilment of, other requirements of the Code on behalf of the chairman, in particular director induction and development. This should be in a manner that is appropriate to the particular director, and which has the objective of enhancing that director's effectiveness in the board or board committees, consistent with the results of the board's evaluation processes. The chairman and the company secretary should periodically review whether the board and the company's other governance processes, for example board and committee evaluation, are fit for purpose, and consider any improvements or initiatives that could strengthen the governance of the company.

2.4. The company secretary's effectiveness can be enhanced by his or her ability to build relationships of mutual trust with the chairman, the senior independent director and the non-executive directors, while maintaining the confidence of executive director colleagues.

Three – Decision Making

3.1. Well-informed and high-quality decision making is a critical requirement for a board to be effective and does not happen by accident. Flawed decisions can be made with the best of intentions, with competent individuals believing passionately that they are making a sound judgment, when they are not. Many of the factors which lead to poor decision making are predictable and preventable. Boards can minimise the risk of poor decisions by investing time in the design of their decision-making policies and processes, including the contribution of committees.

3.2. Good decision-making capability can be facilitated by:

- high-quality board documentation;
- obtaining expert opinions when necessary;
- allowing time for debate and challenge, especially for complex, contentious or business-critical issues;
- achieving timely closure; and
- providing clarity on the actions required, and timescales and responsibilities.

3.3. Boards should be aware of factors which can limit effective decision making, such as:

- a dominant personality or group of directors on the board, which can inhibit contribution from other directors;
- insufficient attention to risk, and treating risk as a compliance issue rather than as part of the decision-making process, especially in cases where the level of risk involved in a project could endanger the stability and sustainability of the business itself;
- failure to recognise the value implications of running the business on the basis of self-interest and other poor ethical standards;
- a reluctance to involve non-executive directors, or of matters being brought to the board for sign-off rather than debate;
- complacent or intransigent attitudes;
- a weak organisational culture; or
- inadequate information or analysis.

3.4. Most complex decisions depend on judgment, but the judgment of even the most well intentioned and experienced leaders can, in certain circumstances, be distorted. Some factors known to distort judgment in decision making are conflicts of interest, emotional attachments, and inappropriate reliance on previous experience and previous decisions. For significant decisions, therefore, a board may wish to consider extra steps, for example:

- describing in board papers the process that has been used to arrive at and challenge the proposal prior to presenting it to the board, thereby allowing directors not involved in the project to assess the appropriateness of the process as a precursor to assessing the merits of the project itself; or
- where appropriate, putting in place additional safeguards to reduce the risk of distorted judgements by, for example, commissioning an independent report, seeking advice from an expert, introducing a devil's advocate to provide challenge, establishing a sole purpose sub-committee, or convening additional meetings. Some chairmen favour separate discussions for important decisions; for example, concept, proposal for discussion, proposal for decision. This gives executive directors more opportunity to put the case at the earlier stages, and all directors the opportunity to share concerns or challenge assumptions well in advance of the point of decision.

3.5. Boards can benefit from reviewing past decisions, particularly ones with poor outcomes. A review should not focus just on the merits of the decision itself but also on the decision-making process.

Four – Board Composition and Succession Planning

4.1. Appointing directors who are able to make a positive contribution is one of the key elements of board effectiveness. Directors will be more likely to make good decisions and maximise the opportunities for the company's success in the longer term if the right skill sets are present in the boardroom. This includes the appropriate range and balance of skills, experience, knowledge and independence. Non-executive directors should possess critical skills of value to the board and relevant to the challenges facing the company.

4.2. The nomination committee, usually led by the chairman, should be responsible for board recruitment. The process should be continuous and proactive, and should take into account the company's agreed strategic priorities. The aim should be to secure a boardroom which achieves the right balance between challenge and teamwork, and fresh input and thinking, while maintaining a cohesive board.

4.3. It is important to consider a diversity of personal attributes among board candidates, including: intellect, critical assessment and judgement, courage, openness, honesty and tact; and the ability to listen, forge relationships and develop trust. Diversity of psychological type, background and gender is important to ensure that a board is not composed solely of like-minded individuals. A board requires directors who have the intellectual capability to suggest change to a proposed strategy, and to promulgate alternatives.

4.4. Given the importance of committees in many companies' decision-making structures, it will be important to recruit non-executives with the necessary technical skills and knowledge relating to the committees' subject matter, as well as the potential to assume the role of committee chairman.

4.5. The chairman's vision for achieving the optimal board composition will help the nomination committee review the skills required, identify the gaps, develop transparent appointment criteria and inform succession planning. The nomination committee should periodically assess whether the desired outcome has been achieved, and propose changes to the process as necessary.

4.6. Executive directors may be recruited from external sources, but companies should also develop internal talent and capability. Initiatives might include middle management development programmes, facilitating engagement from time to time with non-executive directors, and partnering and mentoring schemes.

4.7. Good board appointments do not depend only on the nomination committee. A prospective director should carry out sufficient due diligence to understand the company, appreciate the time commitment involved, and assess the likelihood that he or she will be able to make a positive contribution.

Five – Evaluating the Performance of the Board and Directors

5.1. Boards continually need to monitor and improve their performance. This can be achieved through board evaluation, which provides a powerful and valuable feedback mechanism for improving board effectiveness, maximising strengths and highlighting areas for further development. The evaluation process should aim to be objective and rigorous.

5.2. Like induction and board development, evaluation should be bespoke in its formulation and delivery. The chairman has overall responsibility for the process, and should select an appropriate approach and act on its outcome. The senior independent director should lead the process which evaluates the performance of the chairman. Chairs of board committees should also be responsible for the evaluation of their committees.

5.3. The outcome of a board evaluation should be shared with the whole board and fed back, as appropriate, into the board's work on composition, the design of induction and development programmes, and other relevant areas. It may be useful for a company to have a review loop to consider how effective the board evaluation process has been.

5.4. The Code recommends that FTSE 350 companies have externally-facilitated board evaluations at least every three years. External facilitation can add value by introducing a fresh perspective and new ways of thinking. It may also be useful in particular circumstances, such as when there has been a change of chairman, there is a known problem around the board table requiring tactful handling, or there is an external perception that the board is, or has been, ineffective.

5.5. Whether facilitated externally or internally, evaluations should explore how effective the board is as a unit, as well as the effectiveness of the contributions made by individual directors. Some areas which may be considered, although they are neither prescriptive nor exhaustive, include:

- the mix of skills, experience, knowledge and diversity on the board, in the context of the challenges facing the company;
- clarity of, and leadership given to, the purpose, direction and values of the company;
- succession and development plans;
- how the board works together as a unit, and the tone set by the chairman and the CEO;
- key board relationships, particularly chairman/CEO, chairman/senior independent director, chairman/company secretary and executive/non-executive;
- effectiveness of individual non-executive and executive directors;
- clarity of the senior independent director's role;
- effectiveness of board committees, and how they are connected with the main board;
- quality of the general information provided on the company and its performance;
- quality of papers and presentations to the board;
- quality of discussions around individual proposals;

- process the chairman uses to ensure sufficient debate for major decisions or contentious issues;
- effectiveness of the secretariat;
- clarity of the decision processes and authorities;
- processes for identifying and reviewing risks; and
- how the board communicates with, and listens and responds to, shareholders and other stakeholders.

Six – Audit, Risk and Remuneration

6.1. While the board may make use of committees to assist its consideration of audit, risk and remuneration, it retains responsibility for, and makes the final decisions on, all of these areas. The chairman should ensure that sufficient time is allowed at the board for discussion of these issues. All directors should familiarise themselves with the associated provisions of the UK Corporate Governance Code and its related guidance, and any relevant regulatory requirements.

6.2. Sufficient time should be allowed after committee meetings for them to report to the board on the nature and content of discussion, on recommendations, and on actions to be taken. The minutes of committee meetings should be circulated to all board members, unless it would be inappropriate to do so, and to the company secretary (if he or she is not secretary to the committee). The remit of each committee, and the processes of interaction between committees and between each committee and the board, should be reviewed regularly.

Seven – Relations with Shareholders

7.1. Communication of a company's governance presents an opportunity for the company to improve the quality of the dialogue with its shareholders and other stakeholders, generating greater levels of trust and confidence.

7.2. The annual report is an important means of communicating with shareholders. It can also be used to provide well thought-out disclosures on the company's governance arrangements and the board evaluation exercise. Thinking about such disclosures can prompt the board to reflect on the quality of its governance, and what actions it might take to improve its structures, processes and systems.

7.3. The Code emphasises the importance of continual communication with major shareholders, and of the AGM, as two aspects of a company's wider communications strategy. The chairman has a key role to play in representing the company to its principal audiences, and is encouraged to report personally about board leadership and effectiveness in the corporate governance statement in the annual report.

Appendix

FRC Codes and Guidance and Other Sources of Information

FRC Codes and Guidance

The **UK Corporate Governance Code** sets out recommended practices for listed companies. All companies with a Premium Listing of equity shares in the UK are required to report on the extent to which they have complied with the Code (this is known as 'comply or explain').

Sections A and B of the Code address the leadership and effectiveness of the board, and this guidance is intended to assist boards in considering how to apply the principles in those sections of the Code.

Section C of the Code addresses financial and business reporting, risk management and internal control, and the role of the audit committee. The FRC has issued three guidance notes on these matters:

- Going Concern and Liquidity Risk: Guidance for Directors of UK Companies
- Internal Control: Guidance for Directors
- Guidance on Audit Committees

The **UK Stewardship Code** sets out good practice for institutional investors on engaging with the companies in which they invest.

These documents can all be downloaded from the FRC website:

http://www.frc.org.uk/publications/pubs.cfm

or obtained free of charge from FRC Publications (telephone: 020 8247 1264, e-mail: customer.services@cch.co.uk or online at: www.frcpublications.com)

Directors' Duties

The legal duties of directors of UK companies are set out in sections 170 to 177 of the Companies Act 2006. The Act can be found at:

http://www.legislation.gov.uk/ukpga/2006/46/contents

Other Sources of Information

Note: this is not a comprehensive list. Other sources of information and advice are available.

The **Institute of Chartered Secretaries and Administrators** (ICSA) provides guidance on a wide range of board-related matters, for example, specimen terms of reference for board committees. This guidance can be found at:

http://www.icsa.org.uk/policy-guidance/consultations/improving-board-effectiveness/new-guidance-notes

The **Institute of Directors** (IOD) provides a wide range of guidance notes for directors, which are available at:

http://www.iod.com/Home/Business-Information-and-Advice/Being-a-Director/

Smaller listed companies may find the guidance produced by the **Quoted Companies Alliance** (QCA) useful. This can be found at:

http://www.theqca.com/shop/guides/

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