

Irish
Association
of Investment
Managers

Corporate Governance Review 2001

Report & Commentary

Corporate Governance Review 2001 (ISEQ)

Executive Summary

Summary of Key Findings:

	Percentage of companies on ISEQ
Separate Chairman & Chief Executive	79%
A majority of NEDs on the Board	60%
A Nomination Committee	53%
Re-election of all directors every 3 years	97%
Audit Committee comprised of NEDs only	79%
Remuneration Committee comprised of NEDs only	85%
Senior Independent Director	53%

	Market Cap		
	> €1b	€1b-€100m	< €100m
Separate Chairman & Chief Executive	77%	81%	79%
A majority of NEDs on the Board	77%	42%	67%
A Nomination Committee	92%	58%	33%
Re-election of all directors every 3 years	84%	96%	82%
Audit Committee comprised of NEDs only	100%	81%	70%
Remuneration Committee comprised of NEDs only	100%	88%	76%
Senior Independent Director	69%	69%	33%

Key Conclusions & Recommendations:

- IAIM considers that Irish companies have a very high level of compliance with the Combined Code. This shows that corporate governance is taken seriously by Irish companies, and underpins the creditability of the Irish market as a place to invest.
- As would be expected, there are a number of areas where IAIM would like to see improvements or where the basic principles underlying the Combined Code need to be fleshed out. These are set out in the following recommendations:
 - The separation of the roles of the Chairman and Chief Executive is desirable and IAIM encourages all companies to adopt this position. The reasons offered by companies that do not have a separation of the roles is considered inadequate.
 - IAIM believe that companies should have a majority of non-executive directors (NEDs). While this is in excess of the requirements of the Code we believe that the extensive responsibilities placed on NEDs make this desirable.
 - The definition of an independent NED is currently vague and the IAIM intends to engage with companies to achieve a mutually agreed definition of independence.
 - There is a greater need for Boards to nominate a Senior Independent Director. This guideline has the lowest compliance rate and the IAIM recommends that all companies should appoint a Senior Independent Director.
 - There is a need for internal limitations on Board service in order to introduce fresh perspectives onto Boards on a regular basis. In addition, companies should establish internal retirement ages for senior executives.
 - Companies need to establish Nomination Committees to make recommendations to the Board on all new Board appointments. Companies should also encourage senior executives to take up an external directorship, thus broadening their expertise and the available pool of NEDs.
 - The quality of Remuneration Committee reports varies considerably. These reports need to give shareholders a detailed description of the remuneration policies being applied.
 - All companies need to have an Audit Committee comprising of at least three NEDs. To help the committee fulfil its duties the IAIM recommends that all companies have an internal audit function.

Corporate Governance Review 2001

Report & Commentary

1. Corporate Governance in an International Context

It is only in the past 15 years or so that the concept of Corporate Governance in publicly quoted companies began to be a focus of interest to shareholders, financial analysts and stakeholders.

The publication of the IAIM's Code of Corporate Governance in May 1992 preceded the UK's Cadbury Code by a number of months. The OECD published its Corporate Governance Guidelines in 1999. Corporate Governance Guidelines have also been issued in a number of mainland European countries including France (1998), Belgium (1998) and Germany (2000). In the US, large pension funds such as CALPERs and TIAA-CREF have issued policy statements on corporate governance. In 1998, the Combined Code replaced the UK's Cadbury Code and was, in turn, adopted by the IAIM as the corporate governance standard for Irish quoted companies.

What comes through from an evaluation of various country codes is a realisation that each is rooted in the preoccupations of domestic markets. Governance issues which assume high importance in one country may not feature in another.

For example, the principle of one share/one vote – which is taken for granted in Ireland, the UK and US – is a major concern in the Corporate Governance Codes of continental European markets. The concept of pre-emption rights – so fundamental to Irish and UK shareholders – does not exist in many countries. The concept of anti-takeover devices, a rarity in Ireland and the UK, features largely as a corporate governance issue in the US and continental Europe. The desirability of the separation of the roles of Chairman and Chief Executive – a key element of the Combined Code – has only recently emerged as an issue in the US. The independence of non-executive directors is accepted globally as a crucial part of corporate accountability; yet there is no agreement worldwide on the proportion of the Board which should be made up of “independent” directors or, equally importantly, on a definition of “independence”.

However, the essence of all Corporate Governance guidelines – regardless of which country they apply to – is an acknowledgment that societies and economies have an overriding stake in the development and vitality of quoted companies. The requirement for good corporate governance is an essential part of modern business life. Shareholders are focusing increasingly on the governance of quoted companies, as well as on their financial performance, on the basis that good governance leads to good performance. In so doing, they also acknowledge that perfect corporate governance structures do not, of themselves, guarantee superior performance; conversely, superior performance can be achieved in the context of less than perfect governance structures.



2. Introduction to Review of Compliance of Companies with the Combined Code

The Combined Code, which succeeded the Cadbury Code, was introduced in 1998. The London and Irish Stock Exchanges require companies to state whether or not they are in compliance with the Code and, if applicable, to list those areas where they are not in compliance. Since 1 January 2001 the Irish Stock Exchange has also required full disclosure of remuneration by individual director, thus bringing all aspects of the Combined Code into operation insofar as Irish quoted companies are concerned.

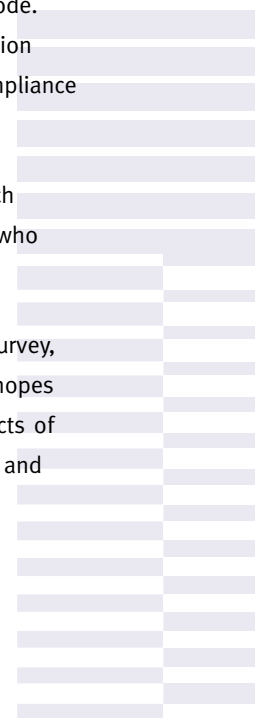
In carrying out this Review, the IAIM wished to ascertain the level of compliance by all companies listed on the ISEQ with the Code.

As part of the review process, the Association sought input from the Chairmen of the relevant companies on the factors which it should take into account in carrying out the review. The Association also summarised relevant information from companies' Annual Reports and requested companies to verify or update the information.

The Association is very pleased that there is a very high level of compliance with the Combined Code. As might be expected, there are a number of areas which the Association feels merit further attention and it will be entering into discussions with some companies in relation to specific aspects of compliance with the Code. IAIM will also be following up with a further analysis next year.

The IAIM would like to record its appreciation of the many positive and thoughtful comments which it received from companies in the course of this review. It would also like to thank all companies who contributed and responded to the survey.

In preparing this analysis, IAIM has focussed primarily on key issues which have arisen from the survey, rather than adopt a box ticking exercise in relation to each element of the Code. The Association hopes that the comments it has made in this report – which deal primarily, but not exclusively with aspects of the Code – will be seen as being constructive and of assistance to companies who wish to attain, and maintain, the highest corporate governance standards.



3. Board Balance

3.1 Separation of the Roles of Chairman & Chief Executive

The Combined Code says that “there are two key tasks at the top of every public company – the running of the Board and the executive responsibility for the running of the company’s business. There should be a clear division of responsibilities at the head of the company which will ensure a balance of power and authority, such that no one individual has unfettered powers of decision”. The Code goes on to say that “a decision to combine the posts of chairman and chief executive officer in one person should be publicly justified”.

The desirability of the separation of the roles of Chairman and Chief Executive has been a long held view of Irish, and indeed UK, shareholders. It is also a view which is becoming more prevalent in the US which has had a long history of combining these roles.

Of the top 15 companies, representing 88% of the market capitalisation of the ISEQ, 12 have a separate Chairman and Chief Executive.

There was widespread support for the separation of roles in the responses from companies; this is borne out by the practice of most companies in this area. Indeed, one respondent said “We believe strongly in the separation of the roles of Chairman and Chief Executive and have always applied this in practice. The only exception to this that might be considered would be in the case of some emergency where for a clearly defined limited period it might be necessary to combine the two roles. However, as a general rule and in normal circumstances we see the two roles as being quite separate and would regard it as an inappropriate concentration of power for one person to hold both positions”.

The IAİM concurs with this view. Clearly, circumstances will arise from time to time which necessitate a combination of roles; this, however, should be a short term measure only.

One of the primary responsibilities of an independent Chairman is to ensure that the Chief Executive is and continues to be the appropriate person for the position. This is clearly not feasible where both positions are combined in one person. Neither is it fair or appropriate to rely on non-executive directors to fulfill this responsibility; the reality is that they probably owe their positions on the Board to the Chairman/Chief Executive.

The Combined Code requires that there should be public justification where these important positions are combined. It also suggests that, in considering justifications by companies for departures from best practice, “those concerned with the evaluation of governance should do so with common sense and with due regard to companies’ individual circumstances”.

The IAİM considers that the justifications given by companies for a combination of the roles of Chairman and Chief Executive are inadequate. They do not address one of the fundamental accountability issues within companies – the responsibility of the Chairman and Board to engage or disengage the services of the Chief Executive.

3.2 Non Executive Directors & the Board

Both the Combined Code and shareholder expectations place a very large responsibility on non-executive directors (NEDs) of companies. In addition to their main Board duties, NEDs are required to serve on Audit, Remuneration and Nomination committees. NEDs are, in a very real sense, the shareholders' representatives on the Board. They also share the same legal responsibilities as executive directors, although operating in a non-executive capacity.

The IAIM believes that the remuneration of NEDs should be appropriate to the very onerous responsibilities which they bear.

3.3 Appropriate Number of NEDs

The Combined Code suggests that "the Board should include NEDs of sufficient calibre and number for their views to carry significant weight in the Board's decisions. NEDs should comprise not less than one third of the Board." The Code also suggests that the majority of NEDs should be independent.

The Association considers that the Code's requirement that NEDs should comprise not less than one third of the Board to be NEDs is very much a minimum requirement. Indeed, this view is shared by most companies on the ISEQ as they themselves have a majority of NEDs.

Given their extensive responsibilities, NEDs which comprise a minority (or arguably an equality) of Board members must face considerable pressure in serving on Audit, Remuneration and, where necessary, Nomination committees. These pressures can be further exacerbated by the Code's requirement that the majority of NEDs be independent.

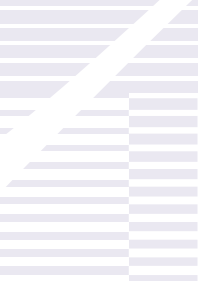
The Association's preference is for companies to have a majority of NEDs. It considers that companies with a minority of NEDs should begin a programme of increasing this number to, at minimum, an equality of executive and non-executive directors.

3.4 Independence of NEDs

In proposing that the majority of NEDs be independent, the Code is quite non-specific in defining independence; it suggests that NEDs should be "independent of management and free from any business or other relationship which could materially interfere with the exercise of their independent judgement. NEDs considered by the Board to be independent in this sense should be identified in the Annual Report".

In evaluating the independence of NEDs, the IAIM has used the following criteria:

- Should not be a recent former executive
- Should not have a business relationship with the company or be a partner/employee in a firm with such a relationship
- Should not be in receipt of consultancy payments or share options
- Should not have significant personal ties to key directors or senior management



The IAIM has considered a number of responses which argue that because a NED was a former executive of the company this does not mean that s/he is not, in fact, independent of management. The Association accepts the good intentions of those who have made this point. However, it would argue that, from an external perspective, recent former executives are so familiar with a company's management (whom they may have appointed), operations, history etc that, with the best will in the world, it may be difficult for them to take a truly independent view.

Some corporate governance specialists have proposed that NEDs who have served ten years or more on a Board should cease to be regarded as independent. The IAIM requested comments from companies on this view. There was widespread opposition to the concept that service of a particular period of time on Boards would render NEDs less independent than heretofore. The Association accepts the arguments made by companies in this regard.

The IAIM has noted that a considerable number of companies, in commenting on the independence of their Boards, stated that all its directors were independent; in some instances these would not meet the independence criteria of institutional shareholders as set out above.

The IAIM is happy to state that, regardless of which definition one uses, there was widespread compliance with the requirement that the majority of NEDs should be independent. Differences in interpretation as to independence can lead, however, to different views between companies and shareholders as to whether NEDs who are members of Remuneration Committees, for example, are truly independent.

Given the importance which is attached to the concept of an independent director, and the Code's requirements in relation to the composition of Audit & Remuneration Committees, the IAIM would welcome proposals from companies which would provide the basis of a mutually agreed definition of independence.

3.5 Senior Independent Directors

The Code recommends that, whether or not the posts of Chairman and Chief Executive are combined, there should be a Senior Independent Director on the Board to whom concerns can be identified.

A number of companies have stated in their Annual Reports that they do not consider this requirement to be a necessary one. Amongst the arguments cited against the proposal are the fact that all NEDs are equal, that any NED can be approached or that it would be invidious to select one NED over another as the Senior Independent Director.

The IAIM understands the views expressed by these companies. However, from the perspective of shareholders, it can be invaluable to have a named Senior Independent Director to whom concerns can be expressed. Indeed, the Association has had reason on a number of occasions to make such contact. In that situation, it is far preferable and cleaner to have a designated director rather than have shareholders addressing concerns to different directors.

The Association considers that the reservations of companies who have not appointed Senior Independent Directors on the grounds that all directors are equal would be met by the rotation, on a bi or triannual basis, of that designation amongst all NEDs. The Association recommends that all companies should appoint a Senior Independent Director.

3.6 Re-Election of All Directors on a Regular Basis

3.7 Terms of Office of NEDs

The Code recommends that “all directors should be required to submit themselves for re-election at regular intervals and at least every three years”. It also recommends that NEDs should be appointed for specified terms subject to re-election and to Companies Acts provisions relating to the removal of a director, and re-appointment should not be automatic”.

From an IAIM perspective, there are two main aspects of this recommendation in the Combined Code.

Re-Election of All Directors on a Regular Basis

The first aspect restates the fundamental right of shareholders to vote, on a regular basis, on the re-appointment or otherwise of a particular director. The Association believes that there should not be any exception to this.

Defined Terms of Office for NEDs

The second aspect refers to the desirability of defined terms of office for NEDs. From its analysis of Annual Reports, and additional information sought from a large number of companies, the Association has noted that companies are taking different approaches to this.

A small number of companies have in place a system whereby NEDs are appointed, subject to re-election by shareholders, for a maximum number of terms of office. (This is qualified by some companies to allow for an extension on an exceptional basis). This approach has a number of considerable benefits. Non-executive directors have a very clear view, from the outset, as to how long they will serve on a particular Board. Board membership should not be seen as a job for life. Most importantly, corporate limits on length of service facilitates the introduction, on a regular basis, of new NEDs, with a fresh perspective, to a Board.

The majority of companies, however, have adopted the approach of appointing directors on the basis of three year terms, subject to re-election by shareholders.

The Association has also noted that a substantial number of companies have chronological cut off point in terms of service as a NED. Such policies may well give rise to accusations of ageism and may not be appropriate in relation to individual NEDs with a particular expertise. In any event, they do not address the desirability of introducing fresh perspectives onto Boards on a regular basis if they are not also accompanied by internal limitations on the terms of office which NEDs may serve.

The IAIM believes that it is the Board’s responsibility to ensure that it has internal limitations on the number of terms a non-executive director may serve. This should not be confused with the rights of shareholders to elect a particular director or not, as the case may be.

The Association considers that the introduction of internal limitations on Board service by NEDs is the preferable approach and recommends to all companies that this be put in place as soon as possible.

3.8 Normal Retirement Ages of Executive Chairmen & Chief Executives

The Combined Code does not address the question of retirement ages of senior executives, including executive chairmen and chief executives.

An analysis of the top 30 companies on the ISEQ has shown that 90% of chief executives/executive chairmen have a retirement age ranging from 60-65, depending on the company. The Association is in full agreement with this policy.

The demands of running and ensuring continued growth in a publicly quoted company are such that there should be reasonable and realistic limitations on length of executive service by chief executives/executive chairmen.

The Association considers that all companies should introduce a time limit on service by senior executives, including the Chief Executive and Executive Chairman.

4. Nomination Committees

The Code provides that, unless a Board is small, a Nomination Committee should be established to make recommendations to the Board on all new Board appointments.

53% of companies on the ISEQ have such a Nomination Committee.

The IAIM is strongly in favour of Nomination Committees which it views as an important means of broadening the range of people who are considered suitable to serve as directors on publicly quoted companies.

As a general comment, the perceived shortage of appropriate people to serve as non-executive directors on quoted company Boards is often cited as a major difficulty. This perception is not unique to the Irish market – it is also a feature of other markets such as the UK.

While the existence of Nomination Committees will hopefully go some way towards broadening the pool of people to be considered for such positions, the Association also considers that it would be helpful if more companies permitted their senior executives to take on an external directorship. The additional experience gained by executives in this situation would be of benefit both to them and their employer companies. It would also have long term benefits for the market as a whole in that, over time, there would be a deeper pool of experienced people from which non-executive directors could be drawn.

5. Remuneration Committees

The Code proposes that Boards of directors should set up Remuneration Committees of independent non-executive directors.

85% of companies surveyed have remuneration committees which are comprised of non-executive directors only. In a number of cases, the independence or otherwise of these directors depends on the interpretation given to the term “independence”. As stated earlier, this may be a source of difference between companies and shareholders and should be resolved through an agreed definition of independence.

5.1 Disclosure of Remuneration

1 January 2001 saw the introduction of full disclosure of remuneration, by individual director, for Irish quoted companies. This requirement will be operative for all companies in the forthcoming reporting season.

Companies are also required to make, in their Annual Reports, a statement of their remuneration policy. The Combined Code considers this statement to be the main vehicle through which the company reports to shareholders on directors' remuneration. The Code proposes that the report should set out the company's policy on executive directors' remuneration and should draw attention to factors specific to the company.

The quality of Remuneration Committee reports surveyed by the Association has varied considerably. Some companies have given shareholders a good understanding of their remuneration policy; others have confined themselves to a short statement of compliance with the Code. To an extent, these varying approaches are to be expected given the very recent introduction of full disclosure.

In essence, the remuneration policy statement is the means by which the Remuneration Committee explains to shareholders the factors underlying their decisions in relation to executive remuneration. Given the fact that levels of executive remuneration can, on occasion, be the subject of criticism or sensitivity, it is of critical importance that the Remuneration Committee communicates its policy on remuneration as clearly and comprehensively as possible.

In communicating its policy, the Committee should inform shareholders, in some detail, of the drivers behind basic and performance related pay, including the criteria for and any limitations on performance pay, and should address the role of long term incentivisation schemes as part of overall incentivisation. In other words, the Committee should give shareholders sufficiently detailed information to enable them to make a reasonable and informed judgement on this aspect of the company's operations. The level of detail required to enable shareholders to have a full understanding of pay issues within a company cannot be given in a few short paragraphs.

The IAİM will be monitoring this area over the next reporting season.

5.2 Other Areas

There are a number of areas which are subject to different disclosure practices by Remuneration Committees.

Share Option & Long Term Incentivisation Schemes

In relation to share option and other long term incentivisation schemes, the Association has noted that a number of companies do not give, on an annual basis, details of the extent of share capital which may be committed to such schemes, the life span of a scheme and the performance requirements for such schemes. It believes that this information is necessary to enable those who have become shareholders since such schemes were approved to have a full understanding of them.

External Advice on Remuneration Packages

The Association recommends that Remuneration Committees, in seeking external advice on the approach they should take to remuneration packages, should preferably use advisors who do not carry out other functions for the company's management.

Service Contracts for Executive Directors

The Code states that "there is a strong case for setting notice or contract periods at, or reducing them to, one year or less. Boards should set this as an objective, but they should recognise that it may not be possible to achieve it immediately. If it is necessary to offer longer notice or contract periods to new directors recruited from outside, such periods should reduce after the initial period".

21% of companies surveyed had service contracts in place for one or more directors. In general, their Annual Reports did not give any indication as to whether or not the Board intended to reduce the terms of these service contracts and within which timescale.

The Association will be monitoring this area over the forthcoming reporting season.

6. Audit Committees & Internal Control

79% of companies fulfilled the Code's requirement that Audit Committees, comprising at least three non-executive directors, should be established.

The Code also recommends that companies which do not have an internal audit function should from time to time review the need for one. In this regard, the IAİM noted that a minority of companies do not have such a function. The Association has considerable difficulty in understanding how an Audit Committee of NEDs, regardless of the size of the company, can carry out its duties effectively, in the interests of shareholders, in the absence of an internal audit function.

The Association recommends that all companies put in place an internal audit function (which may be sourced externally), or at a minimum, explain why this proposal is not appropriate. It will be monitoring this situation closely over the next year.

The Association has also noted that, in a number of cases, the company's non-executive chairman also acts as chairman of the Audit Committee. The Combined Code is silent on the appropriateness or not of the company chairman serving in this capacity. Indeed, the IAİM itself has no absolute views on this area. However, it considers that this is an area worth raising for discussion; it could be argued that the demanding nature of a Chairman's role and the need for the Chairman to have oversight of all areas within the company would suggest that an independent non-executive member of the Board would be best placed to chair the Audit Committee.



7. Statement of matters reserved for the Board

The Code requires companies to have a formal schedule of matters specifically reserved to it for decision.

There have been different practices evident in this area, with some companies giving a detailed overview of the matters which are reserved for Board decision and others making a statement that there are (unspecified) matters reserved for the Board.

Shareholders should be given sufficient information on the matters reserved for Board decision to enable them to be satisfied that the appropriate balance between Board and Board committee or executive responsibility has been maintained.

8. Turnbull Guidance on Internal Control

The Combined Code requires companies to “maintain a sound system of internal control to safeguard shareholders’ investment and the company’s assets”. Practical guidance on the implementation of this requirement, known as the Turnbull Report, was published in 1999 and companies were allowed a transitional period for full implementation.

As many companies were in a transitional phase when this survey was being carried out, the Association has not reviewed compliance with the Turnbull Guidance. It will, however, be evaluating the quality of company reporting in this area in its next survey. The Association will be looking, in particular, for a level of disclosure which will enable shareholders to make a reasonable evaluation of the quality of internal control and related procedures.

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