Chapter 7 – Corporate governance

Skyweb plc is a large company specialising in software research. Its board consists of ten directors, six of whom hold executive office, with each director requiring re-appointment every four years. The company’s shares have been listed on the London Stock Exchange for the last two years.

The company decides to expand its board by appointing two new directors, one of whom will be a non-executive director. The board’s nomination committee, which consists of three non-executives and two executives (one of whom is the company’s Chairman), nominate several candidates to be put to the general meeting. Unfortunately, one member of the nomination committee did not contribute to the committee’s work, as he was recently appointed for the first time to the office of director and had not yet received any training on his roles and responsibilities.

The company has made a handsome profit. Accordingly, the executives believe that all the directors of the board should receive a 25 per cent pay rise. The pay increase is agreed upon at a meeting of the entire board. The remuneration of all the directors consists solely of a base salary and the directors’ service contracts are two years in length.

Several large institutional investors have expressed concern over the competence of the company’s auditor. Accordingly, it is decided that Skyweb will appoint a new auditor. John, the CEO and Chairman, has a friend of his who has a reputation for being a very competent and thorough auditor. Accordingly, John convinces the board that his friend should be nominated. The appointment is confirmed by the company at the AGM. The newly-appointed auditor also provides additional non-audit services to the company as and when required.

Adam is considering purchasing a substantial number of shares in MultiTech. However, he is concerned about the company’s commitment to good corporate governance practices and, based on the above events, he asks for your advice regarding any examples of poor corporate governance practices that the company might have engaged in.

Introduction

- This question requires you to advise a potential shareholder, who has concerns about the company he may invest in. There are a few basic details that you may wish to mention early on, as they will be relevant throughout your answer (e.g. the company is listed). You may also wish to mention that, as we are focusing on Skyweb’s commitment to corporate governance, your answer will focus on to what extent Skyweb is complying with the UK Corporate Governance Code (the Code). Mention also that the recommendations of the Code are voluntary (even for listed companies) and that a failure to follow the Code’s recommendations may not necessarily imply that the company is not committed to improving standards of corporate governance.
You will then want to identify the ways that Skyweb’s practices differ from those recommended by the Code. Skyweb has deviated from the Code’s recommendations in numerous ways.

**Composition of the board**

- At the start of the question, Skyweb has ten directors, only four of whom are non-executive directors. The company then expands its board by two, so that it has seven executive directors and five non-executive directors.
- **Principle B.1.2** of the Code provides that, except for smaller companies, at least half the board excluding the Chairman should consist of independent non-executive directors. Unless Skyweb qualifies as a smaller company, it will not have implemented this recommendation of the Code.

**Re-appointment**

- The opening paragraph informs you that the directors require re-appointment every four years. **Principle B.7** of the Code provides that ‘[a]ll directors should be submitted for re-election at regular intervals …’ The Code (at B.7.1) then goes onto provide that all directors of FTSE 350 companies and non-executive directors should be subject to annual re-election. All other directors should be re-appointed every three years. Accordingly, Principle B.7.1 has not been complied with.

**Nomination committee**

- You are told that the board’s nomination committee consists of three non-executives and two executives (one of whom is the Chairman). **Principle B.2.1** provides that the process of board appointments should be led by a nomination committee, and the majority of members of the committee should be independent non-executive directors. This recommendation has been met. The fact that the Chairman is a member of the committee is not a problem as B.2.1 states that the nomination committee should be chaired by the Chairman or an independent non-executive director (although the Chairman should not chair the meeting where the appointment of his successor is being discussed).
- You are told that one member of the nomination committee has not contributed to the committee’s work as he has recently become a director and has yet to receive the relevant training. **Principle B.4** provides that [a]ll directors should receive induction on joining the board and should regularly update and refresh their skills and knowledge. The supporting principle states that the Chairman should ‘ensure that the directors continually update their skills and the knowledge and familiarity with the company required to fulfil their role both on the board and on board committees.
- **Principle B.4.1** backs this up by stating that the Chairman should ‘ensure that new directors receive a full, formal and tailored induction on joining the board.’ Accordingly, it could be argued that the director’s induction should have been tailored to his needs, including training on how to fulfil his role as a member of the nomination committee.
Remuneration

- The board has agreed to award all directors a 25 per cent pay increase. This provides a good example of a situation where the provisions of the Code are more important than the provisions of the CA 2006 or the model articles.
- The model articles provide that the directors can determine their own remuneration. Principle D.2.1 of the Code, however, states that the executives’ remuneration should be determined by a remuneration committee consisting of at least three independent non-executive directors (two in the case of a smaller company). Clearly, Skyweb has not complied with this recommendation.
- Main Principle D.1 states that ‘[a] significant proportion of the executive directors’ remuneration should be structured so as to link rewards to corporate and individual performance.’ As the directors of Skyweb receive a base salary only, this recommendation has also not been complied with.
- Finally, the directors have service contracts of two years in length. Principle D.1.5 provides that '[n]otice or contract periods should be set at one year or less.'

Auditor

- A new auditor is appointed at the AGM. This auditor is a friend of Skyweb’s Chairman, although the question does not imply anything untoward about this – in fact, the Chairman knows the auditor to be thorough. However, Principle C.3.1 states that the board should establish an audit committee of at least three independent non-executive directors (two in the case of a smaller company). This committee should make recommendations to the board regarding the appointment, re-appointment and removal of the company’s auditor. Clearly, this recommendation has been breached.
- The new auditor also provides the company with additional non-audit services. Auditors can earn substantial amounts through such services, which can create a conflict of interest. If the auditor causes the company trouble, they may refuse to engage him for such additional work. Accordingly, it has been argued that an auditor’s independence may be affected if he also provides the company with non-audit work.
- To combat this, Principle C.3.7 states that the company should, in its annual report, explain how the auditors’ objectivity and independence is to be safeguarded if he also provides the company with additional non-audit services.

Comply or explain

- The above would seem to indicate that Skyweb has scant regard for good corporate governance practice. However, the Code acknowledges that its recommendations may not be suitable for all companies and listed companies that do not comply with the Code must state why. You may want to mention that, even though Skyweb has failed to implement many of the Code’s recommendations, it may have good reasons for not doing so. These should be stated in the company’s annual report and Adam would be well-advised to obtain a copy of the company’s annual report to see if this is the case.