

REPORT ON COMPLIANCE WITH

THE COMBINED CODE ON CORPORATE GOVERNANCE

BY IRISH LISTED COMPANIES

**Commissioned by the Irish Stock Exchange and
the Irish Association of Investment Managers**

Compliance with the Combined Code on Corporate Governance by Irish listed companies

A Report commissioned by the Irish Stock Exchange
and the Irish Association of Investment Managers
on the Compliance and Disclosure Practices
of Irish Listed Companies.



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Preface

The credibility and effectiveness of a country's domestic governance arrangements are important components of its international reputation. Ireland's reputation has suffered internationally over the past two years, caused largely by issues arising in the domestic banking and semi-state sectors. It is suggested that, along with commercial failures and other factors, corporate governance failures played a part in the domestic financial crisis. Given the significant historic weighting of financial stocks in the ISEQ® Overall Index¹, it appears that the erosion of shareholder value in domestic financial institutions has tainted non-financial ISEQ® stocks in the eyes of international investors. This has created challenges for Irish companies seeking to raise capital in international financial markets.

Corporate governance is multi-faceted in nature and encompasses company law, the regulatory framework, the Listing Rules, the Combined Code on Corporate Governance² (the 'Code'), ethical standards, corporate strategy and government policy. Clearly, failure in any one of these areas will impact on the perception of corporate governance standards. This Report, commissioned by the ISE and the IAIM, deals primarily with one aspect of that mix, namely the Code. Good corporate governance, however, is more than a set of rules or a code; it is a state of mind and a culture that needs to be embedded from government right through to corporate level.

For the listed company sector, Ireland follows best international practice by requiring Irish listed companies to apply the Code. The Financial Reporting Council in the United Kingdom has recently proposed a number of substantial amendments to the Code, some of which reflect the recommendations contained in the Walker Report³. In addition, the expectations of institutional investors and their clients regarding the corporate governance practices of listed companies are changing.

Irish companies now have an opportunity to distinguish themselves from their international competitors and deliver to these changes, not only by adhering to the highest governance standards, but also by demonstrating to investors in a transparent way that the governance culture, process and practices they have in place are robust.

At a time of significant debate about corporate governance, this Report presents the findings of a Review, conducted by an independent researcher, of the extent of compliance by Irish listed companies with the Code and a qualitative assessment of their related disclosures. In addition, the Report sets out recommendations for consideration by the boards of listed companies that may assist them in proactively enhancing the quality and meaningfulness of the corporate governance disclosures contained in their annual reports with a view to:

- Demonstrating to international investors the robustness of their governance frameworks in a way that delivers confidence in each company and its board; and
- Providing evidence to investors that the governance mechanisms within the company are working properly and that the spirit, as well as the letter, of the Code is being complied with and is supported by underlying board behaviour.

FOOTNOTES – PREFACE

- 1 Financial shares comprised 40.43% and 38.26% of the ISEQ® Overall Index in 2006 and 2007, respectively.
- 2 Financial Reporting Council (2008), *The Combined Code on Corporate Governance*, Financial Reporting Council, United Kingdom.
- 3 Walker, D. (2009), *A Review of Corporate Governance in UK Banks and other Financial Industry Entities*, H.M. Treasury, United Kingdom.

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Chapter 1

Executive Summary

1.1 Scope of the Review

In Quarter 4 2009, the ISE and the IAIM commissioned an independent and detailed review of the level of compliance by Irish incorporated companies listed on the Main Market of the Irish Stock Exchange with the Code and the related disclosures provided in their annual reports (the Review). The Review findings were examined and commented on by a Review Panel established by the ISE and the IAIM (details in section 2.4 of the Report).

1.2 Purpose of the Report

The overall objective of this Report is to provide an assessment of the level of compliance by Irish listed companies with the Code and their related disclosures and, where appropriate, to identify issues which may assist the boards of listed companies in disclosing more meaningful information to investors in their annual reports in the future. In summary, firstly the Report provides an objective assessment of actual compliance based on current standards. Secondly, the Report presents a qualitative assessment of annual report disclosures and seeks to identify what further improvements could be made to demonstrate compliance with the spirit (rather than just the letter) of the Code. This latter point is particularly relevant given the shifting expectations of investors and the emerging changes to the Code.

1.3 Main Observations

The main observations of the Review Panel arising from the Review are detailed below:

HIGH LEVEL OF COMPLIANCE WITH THE CODE

The findings of the Review indicate that there was a high level of compliance by Irish listed companies with the Code during the 2008 financial year. It is evident from the Review that listed companies take corporate governance seriously and have put considerable effort into building a robust governance framework based on the principles enshrined in the Code. It is encouraging to note that a small number of companies are voluntarily adopting good governance practices beyond Code requirements.

FURTHER STEPS TO IMPROVE THE QUALITY OF CORPORATE GOVERNANCE DISCLOSURES

The Review indicates that Irish listed companies are meeting disclosure obligations under the Listing Rules and under the Code regarding: (a) how they have applied the Code's principles; and (b) why they have diverged from specific Code provisions. However, the Review highlights that further steps could be taken by boards to enhance the quality/meaningfulness/usefulness of disclosures contained in the annual report for investors, as outlined in Key Recommendations (section 1.4) below.

DIRECTORS SEE REAL VALUE IN CORPORATE GOVERNANCE

As part of the Review, a meeting was held with a sample of listed company directors. The findings from the discussions with these directors highlight the value that compliance with high corporate governance standards is seen to deliver.

THE IRISH INVESTOR PERSPECTIVE

Concurrent with the Review, the views of Irish institutional investors were sought. It is clear that to meet the evolving needs of institutional investors companies should place more emphasis on disclosure in the following areas:

- The introduction of 'say on pay' votes on a non-binding basis at annual general meetings;
- An enunciation of the skill sets brought to the board by the sitting non-executive directors (NEDs) and the rationale for their appointment to particular board committees;
- A commentary on the policy for board renewal and on the independence of NEDs;
- A tailored discussion of the principal risks facing the business and a reflection on how these are dealt with both at board and board committee level;
- More detail than is currently the norm on the processes by which the performance of NEDs and the chairman are evaluated;
- An explanation in the annual report of how compliance with EU Guidance on Remuneration in Listed Companies is achieved; and
- Where non-compliance is being explained a comprehensive company specific rationale for that non-compliance.

1.4 Key Recommendations

Overall, the Review highlights a number of key points for consideration by the boards of listed companies:

IMPORTANCE OF THE ANNUAL REPORT

Research confirms that the annual report is an important document for communicating with investors⁴. In addition, it is the principal vehicle under the Listing Rules and the Code for delivering corporate governance disclosures to investors. Boards should use their annual reports to demonstrate that the governance culture, processes and procedures within their companies deliver to the spirit, as well as the letter, of the Code, thereby earning additional investor trust and confidence.

HIGH QUALITY DISCLOSURES

Boards should embrace confident and persuasive communications with shareholders and seek to avoid boiler-plate/uninformative descriptions and explanations. The bespoke nature of the Code regime demands disclosures that are also bespoke. There is scope for providing investors with more meaningful and contextual disclosure on how the principles of the Code have been applied and in explanations for divergence from the Code's provisions.

UNDERLYING BOARD BEHAVIOUR

The principles of the Code are intended to encourage appropriate board behaviours. To be effective good governance needs to be implemented in a way that fits the culture and business of the individual company. It is important that the governance disclosures provided in the annual report accurately reflect and are supported by the underlying behaviour of the board.

SPECIFIC RECOMMENDATIONS

On foot of the Review findings, a number of specific recommendations have been identified for consideration by listed company boards on how the meaningfulness of disclosures contained in the annual report can be enhanced for investors in the future, especially in relation to the following areas:

- Explanations for divergence from the Code’s provisions;
- Board balance;
- Non-executive director independence;
- Board refreshment;
- The work of key board committees; and
- Performance evaluation.

FOOTNOTES – CHAPTER 1

- 4 Commonly cited research in this area includes: Epstein, M.J. and Freedman, M. 1994, ‘Social disclosure and individual investor’, *Accounting, Auditing and Accountability Journal*, Vol. 7, No. 4, pp. 94–109; and Hines, R. 1982, ‘The usefulness of annual reports: the anomaly between the efficient markets hypothesis and shareholder surveys’, *Accounting and Business Research*, Vol. 12, No. 48, pp. 296–309.

Chapter 2

Review Objectives and Methodology

2.1 Scope of the Review

The Review applied to Irish incorporated companies with securities admitted to the Official List and to trading on the Main Market of the Exchange as of 30 September 2009.

The Review excluded:

- Waterford Wedgwood plc as on 5 January 2009, following the appointment of a receiver and the suspension of its securities from listing and trading on the Exchange;
- Non-Irish incorporated companies with securities admitted to the Official List and to trading on the Main Market of the Exchange; and
- Companies with securities on the Irish Enterprise Exchange (IEX).

In total, the Review covered 29 companies (the 'Sample Group'), details of which are listed in Appendix 1.

2.2 Review Objectives

The ISE and the IAIM commissioned the independent and detailed Review to:

- 1 Assess the level of compliance by Irish incorporated listed companies with the Combined Code (June 2006)⁵;
- 2 Assess the quality of corporate governance disclosures provided by listed companies in their annual reports;
- 3 Assess the quality of explanations provided by listed companies for non-compliance with the Code;
- 4 Identify practices adopted by companies over and above the Code requirements to improve their governance;
- 5 Identify and reflect the views of Irish listed company directors on corporate governance practices in Ireland;
- 6 Consider corporate governance developments relevant to the Irish listed company sector, including the Review of the Combined Code⁶, the Walker Report (see footnote 3) and the European Commission Study on the Monitoring and Enforcement Practices in Corporate Governance in the Member States;
- 7 Identify and reflect the views of institutional investors on corporate governance practices in Ireland; and
- 8 Identify potential areas for improvement.

2.3 Review Methodology

The Review was carried out during Quarter 4 2009 by an independent researcher, Margaret Cullen⁷. A four-stage review process was implemented.

STAGE 1: REVIEW OF ANNUAL REPORTS OF THE SAMPLE GROUP

Objectives 1 to 4 inclusive were met through a detailed review of the corporate governance sections of the most recent annual reports of the Sample Group to:

- 1 Assess the level of compliance with the Code;
- 2 Assess the quality/usefulness/meaningfulness of disclosures on the principles of the Code (including explanations provided by companies that have not complied with particular Code provisions and the extent to which boiler-plate explanations are used);
- 3 Identify circumstances where companies have taken positive steps (over and above the Code requirements) to apply the principles or otherwise improve their governance.

STAGE 2: REVIEW OF CORPORATE WEBSITES OF THE SAMPLE GROUP

The corporate websites of the Sample Group were reviewed to supplement the review of the annual reports (Stage 1) in assessing the level of compliance with each of the Code's main principles and provisions. Stages 1 and 2 were carried out concurrently.

STAGE 3: DISCUSSIONS WITH DIRECTORS FROM THE SAMPLE GROUP

Following completion of Stages 1 and 2, discussions were held with four company directors⁸ from the Sample Group to identify and reflect the views of Irish listed company directors on corporate governance practices in Ireland (Objective 5). Views were sought from the company directors on the following matters:

- 1 The value placed on corporate governance by boards of directors of Irish listed companies;
- 2 The benefits that accrue to companies from having a strong corporate governance regime;
- 3 The extent to which overseas investors challenge Irish listed companies on corporate governance matters;
- 4 The most significant challenges faced by companies in complying with the principles and provisions of the Code;
- 5 The principal considerations of boards when providing corporate governance disclosures;
- 6 The challenges faced by listed companies in meeting the requirements of the Code, particularly in the current environment; and
- 7 How Irish listed companies are perceived internationally.

The key issues arising from this discussion group are referenced in places in Chapter 4 and summarised in Chapter 5.

STAGE 4: REVIEW OF RECENT GOVERNANCE DEVELOPMENTS

Concurrent with Stages 1 to 3, a review was undertaken of significant governance developments in the UK (Review of the Combined Code and the Walker Report) and Europe (European Commission Study on Monitoring and Enforcement Practices in Corporate Governance in the Member States) with a view to understanding the key corporate governance issues challenging EU companies generally and their implications for Irish listed companies (Objective 6).

2.4 Review Panel

The ISE and the IAIM established a Review Panel to oversee, guide and inform the Review process. The Review Panel met on seven occasions between October 2009 and January 2010.

MEMBERS⁹

- 1 Niamh Brennan (Chair), Michael MacCormac Professor of Management, University College Dublin; Academic Director, Centre for Corporate Governance, University College Dublin;
- 2 Daryl Byrne (Secretary), Head of Strategy Planning and Brand, Irish Stock Exchange;
- 3 Chris Hodge, Head of Corporate Governance, Financial Reporting Council (UK);
- 4 Philip Kearney, Senior Fund Manager, Aviva Investors and Chairman of the Market Instruments Committee of the Irish Association of Investment Managers;
- 5 Aileen O'Donoghue, Director of Strategy, Policy and Communications, Irish Stock Exchange;
- 6 Kevin O'Donovan, Chairman, Audit Committee Institute Ireland; and
- 7 Frank O'Dwyer, Chief Executive, Irish Association of Investment Managers.

TERMS OF REFERENCE

The required function of the Review Panel was to:

- 1 Advise the ISE and the IAIM on the approach to the Review, including the Review objectives and methodology;
- 2 Act as a sounding board on significant issues arising during the Review; and
- 3 Examine and comment on the results of the Review and, where appropriate, to outline issues for consideration by the boards of listed companies in the future.

2.5 Institutional Investor Perspective Sought

The IAIM hosted discussions with its members to identify and reflect the views of the institutional investor community on corporate governance practices in Ireland (Objective 7). The main observations and perspectives are reflected in Chapter 6.

2.6 Consideration of the Review Findings

The Review Panel considered and commented on the findings of the Review and identified issues for consideration by the boards of listed companies in the future (Objective 8). In this context, the Review Panel sought the views of four senior non-executive directors on the core themes in the Report with a view to assessing any practical impediments to the recommendations identified for consideration by the boards of listed companies.

FOOTNOTES – CHAPTER 2

- 5 The Combined Code was revised in June 2008 and the latest edition applies to accounting periods beginning on or after 29 June 2008. As the accounting periods of the companies subject to this Review commenced prior to 29 June 2008, the 2006 edition of the Combined Code has been used.
- 6 Financial Reporting Council (2009), Review of the Combined Code: Final Report, Financial Reporting Council, United Kingdom; and Financial Reporting Council (2009), Consultation on the Revised UK Corporate Governance Code, Financial Reporting Council, United Kingdom.
- 7 Margaret Cullen holds a BA in Economics from UCD and an MSc in Investment and Treasury from DCU. She has over 12 years' financial services industry experience. She began her career as a treasurer in ABN AMRO Irish Financial Services Company Limited. In 1997 she joined the Financial Regulator where she worked in the Securities and Exchanges Supervision Department, regulating mutual funds. In 2000 she moved to JP Morgan Bank (Ireland) plc as Vice President of the Trust and Fiduciary Services Department. She joined RBC Dexia Investor Services Ireland Limited as Head of Risk and Compliance in 2005. Margaret is a UCD Ad Astra Research Scholar and is currently pursuing a PhD in corporate governance at the Centre for Corporate Governance at UCD Michael Smurfit Graduate Business School, where she also lectures on the Diploma in Corporate Governance in the areas of executive remuneration and behavioural aspects of boards.
- 8 The directors included a non-executive chairman and three non-executive directors from Irish companies listed on the ISE. Two large-cap companies (market capitalisation above €1 billion) and two mid-cap companies (market capitalisation below €1 billion) were selected randomly from the Sample Group and the chief executives were requested to nominate the non-executive directors to participate in the discussions. It should be noted that the views of the directors of the Sample Group do not represent those of the 29 listed companies.
- 9 It should be noted that in order to avoid potential conflict of interest issues no representatives from the 29 listed companies were included on the Review Panel.

Chapter 3

Compliance with the Combined Code

This chapter outlines the main findings arising from Stage 1 of the Review on the level of compliance by listed companies with the Code.

3.1 Compliance with the Combined Code 2006

The Code requires that companies either confirm that they have complied with its provisions or, where they do not, provide an explanation. The Code recognises that departure from its provisions may be justified in certain circumstances. In particular, smaller listed companies may judge that some of the provisions are disproportionate or less relevant in their case.

Mechanistic compliance with the Code by companies is no more desirable than companies not embracing the Code. If companies find complying with one of the Code's provisions is difficult, they should exercise the right to diverge from the provision while providing a robust, bespoke explanation to shareholders as to why they have reached this view. Once companies provide an adequate explanation, they are complying with the Code.

HIGH LEVEL OF COMPLIANCE WITH THE CODE

Overall, the Review highlights a high level of compliance by Irish listed companies with the Code during the 2008 financial year. The value placed by boards on corporate governance was reiterated through a discussion group held with a sample of directors of listed companies (see section 5.1 of this Report). Participants in the discussion group clearly understand the reputational benefits accruing to companies with robust governance regimes from investors.

Table 1 summarises the findings of the Review in relation to compliance with the Code by the companies reviewed during the 2008 financial year. Where appropriate, comparisons are included with the findings of the Risk Metrics Group's (RMG) 'Study on Monitoring and Enforcement Practices in Corporate Governance in the Member States' (dated 23 September 2009) published by the European Commission¹⁰.

Table 1: Level of Compliance with the Code – 2008 Annual Reports		
Description	The Review Number of Companies	RMG Study EU Average
Statement outlining how principles have been applied	29	–
Statement on compliance with the Code ¹¹	28	–
Compliance with no explanation required	10 (34%)	22%
Compliance by explanation	19 (66%)	–
Average number of explanations per company	1.8	5 ¹²

This overall Review finding is further supported by the results of a survey by Governance Metrics International¹³ (22 September 2009) which ranked Ireland and the UK in first and second position respectively in relation to overall quality of corporate governance ahead of other countries such as Canada (third), Australia (fourth) and the USA (fifth). The relative high positions of Ireland and the UK in this study are likely to reflect the fact that listed companies in both of these jurisdictions apply the Code. Although the Code is highly rated internationally, it is clear from the final report published by the FRC (see footnote 6) that there is a need for improvements to the Code.

STRONG APPLICATION OF THE PRINCIPLES OF THE CODE

The corporate governance reports reviewed outline the manner in which each company applied the principles of the Code during the 2008 financial year. It was clear that the majority of companies take corporate governance seriously and have put considerable effort into building a robust governance framework based on the principles enshrined in the Code. This was particularly evident in relation to the following important areas:

- 1 Existence of a formal set of matters reserved exclusively for the decision of the board;
- 2 Separation of the roles of chairman and chief executive officer ('CEO')¹⁴ (provision A.2.1);
- 3 Use of committee structures¹⁵ and associated committee terms of reference;
- 4 Existence, in the majority of companies, of a board performance evaluation process;
- 5 Significant focus by the majority of companies on their internal control framework; and
- 6 Emphasis on relations with shareholders.

ADDITIONAL PRACTICES ADOPTED BY COMPANIES

A number of practices were identified by the Review that are being voluntarily adopted by a small number of companies notwithstanding that they are not explicitly required under the Code. The most significant of these practices are:

- 1 The establishment of governance committees (in their own right or as part of the nomination committee);
- 2 The policy of putting the remuneration report to a shareholder vote ('say on pay');
- 3 The policy that all directors resign and seek re-election every year;
- 4 The introduction of corporate governance guidelines and/or codes of best practice; and
- 5 The policy that non-executive directors cannot hold more than three public limited company directorships.

These measures are indicative of a more dynamic approach to governance and demonstrate compliance with the spirit of the Code.

FOOTNOTES – CHAPTER 3

- 10 RMG Study – website link http://ec.europa.eu/internal_market/company/ecgforum/studies_en.htm.
- 11 One company departs from normal practice and alludes to being fully compliant by setting out how the "full principles and provisions of the Code were applied during the year", rather than providing a compliance statement.
- 12 The results of the RMG Study indicate that the average number of explanations per company for Ireland and the UK was one, which compares favourably with the EU average of five. It should be noted that the difference in the average number of explanations per company between the RMG Study (one) and this Review (1.8) reflects a difference in the number of companies subject to review in each study.
- 13 Governance Metrics International is an independent research and ratings agency founded in 2000 to evaluate the corporate governance policies and procedures at companies worldwide.
- 14 In only two of the 29 companies reviewed are the roles combined.
- 15 Specifically the use of audit, nomination and remuneration committees.

Chapter 4

Corporate Governance Disclosures

This chapter outlines the main findings arising from Stages 1 and 2 of the Review on the corporate governance disclosures provided by listed companies in their annual reports. As referred to earlier, the observations in this chapter are intended to highlight areas where, although compliance with the Code is not a concern, improvements in approach could be made which would take into account changing expectations in relation to disclosure practice.

4.1 Explanations under the Code

Given the ‘comply or explain’ approach enshrined in the Code, companies are not required to assert full compliance with its provisions at all times. The very nature of the Code is that it provides flexibility for companies to depart from its provisions as long as the departure is adequately explained in the annual report.

Table 2: Analysis of Explanations Provided in 2008 Annual Financial Statements				
Provisions on which Explanations Provided	Total	Uninformative Explanation¹⁶	Boiler-plate Explanation¹⁷	Adequate Explanation¹⁸
CEO Duality (A.2.1)	3	2	1	–
Majority Independent Board (A.3.2)	7	3	3	1
No Performance Evaluation of the Board (A.6.1)	2	2	–	–
Majority Independent NEDs on Nomination Committee (A.4.1)	2	2	–	–
Independent NEDs on Remuneration Committee (B.2.1)	4	2	1	1
Independent NEDs on Audit Committee (C.3.1)	4	2	1	1
Chairman of Board Chairing the Remuneration Committee (B.2.1)	2	–	2	–
Share Options Granted to NEDs (B.1.2)	4	–	3	1
Length of Executive Service Contracts (B.1.6)	5	1	3	1
Other ¹⁹	16	8	1	7
Total Number of Corporate Governance Explanations Reviewed	49			

As noted in Table 1 (see section 3.1 of this Report), 19 companies provided explanations in the 2008 annual reports. Table 2 provides a breakdown of these explanations by Code provision together with a qualitative assessment of the efficacy of these explanations.

As can be seen from Table 2, in the majority of cases, the suggestion is that uninformative or 'boiler-plate' explanations are provided by companies for deviations from the Code rather than descriptive strategic, business or contextual explanations which explain the bespoke company circumstances requiring the deviation. Section 5.2. of this Report outlines the findings from discussions with listed company directors on the use of 'boiler-plate' language.

There appear to be several reasons why companies might revert to the use of boiler-plate language in their explanations. Firstly, at times, it may be challenging to draft bespoke explanations, particularly where sensitivities exist regarding commercial or personal information. Secondly, where a certain type of explanation is generally regarded in the market as being acceptable, there can be a tendency to adopt this 'accepted' language rather than draft something new which may be out of line with 'normal' practice. Finally, 'boiler-plate' language may reflect distant engagement by boards of directors in the drafting process, with the result that explanations do not receive the due care and attention they require in order to be meaningful for investors.

The tendency to use 'boiler-plate' language under 'comply or explain' corporate governance regimes is common across the EU. In relation to UK companies, this is acknowledged in the Chairman's Preface of the draft revised Combined Code²⁰. In addition, the Risk Metrics Group Study concludes that the practical implementation of the 'comply or explain' approach across the EU suffers some deficiencies, mainly in the form of an unsatisfactory level and quality of information on deviations by companies.

The analysis in Table 2 highlights an opportunity for Irish companies to collectively take steps to enhance the meaningfulness of the explanations provided in their annual reports so that they are more useful to investors in demonstrating compliance with the spirit of the Code.

Recommendations

R1 Explanations for Divergence from Code Provisions

Companies seeking to move away from 'boiler-plate' language when providing explanations under the Code should consider the following points:

- Explanations should clearly reflect the contextual environment within which the company is operating;
- An indication of how and when the company will be in a position to return to compliance with the relevant Code provision(s) should be disclosed;
- In circumstances where the company considers that non-compliance with a particular provision is in the best interests of the company, a robust justification for this opinion should be provided.

4.2 Application of the Code Principles:

Quality of Corporate Governance Disclosures

Companies listed on the ISE are required under the Listing Rules to describe in their annual reports how they apply the principles of the Code. As noted in Chapter 2, an objective of the Review is to assess the quality/meaningfulness/usefulness of disclosures provided by companies on how they have applied these principles.

The annual report is the principal vehicle by which companies can demonstrate the strength of their governance framework and provide a clear insight into their governance culture to existing and potential investors. The quality of the information companies provide influences the governance assessment undertaken by the institutional investor community. That quality is best achieved through clear, unambiguous, comprehensive discussion and disclosure within the annual report. The objective of any disclosure should be to provide the evidence base to enable the distant investor confirm compliance with the spirit (rather than just the letter) of the Code.

The Review clearly highlights that Irish listed companies are meeting their obligations to disclose in their annual reports how they have applied the principles of the Code. The Review, however, identifies a number of areas where further steps could be taken by boards to enhance the quality/meaningfulness/usefulness of disclosures regarding the application of these principles.

STANDARDISED DESCRIPTIONS

- 1 The Review indicates that some companies are using standardised descriptions to demonstrate compliance with the main principles of the Code. This involves taking wording directly from the Code provisions and including it verbatim or slightly amended in the corporate governance statement to demonstrate compliance. Standardised descriptions tend to be uninformative and lack credibility by virtue of not being customised to the individual company.
- 2 The Review notes that, in certain cases, the same narrative is used year on year notwithstanding that the strategic, contextual and other issues that companies deal with change year on year.

Recommendation

R2 Standardised Descriptions

Companies should avoid adopting wording verbatim from the Code and instead should outline in their annual report in a bespoke manner how the principles are actually applied. The description provided should clearly reflect the contextual environment within which companies are operating.

MAIN AREAS FOR ENHANCING DESCRIPTIONS

In demonstrating how the Code's principles have been applied, a number of key areas are identified in the Review as having scope for enhanced disclosure in the annual report, classified between two broad categories: (1) The Board; and (2) The Workings of the Board. Performance evaluation is examined as a separate item at the end of section 4.2.

1 The Board

Good corporate governance is completely dependent on the quality, attributes and governance philosophy of the board of directors. With the exception of those institutional investors that are well acquainted with the board, the visible evidence of board quality is in the disclosures made in annual reports. The Code principle and associated provisions dealing with board balance and independence²¹ address the balance of executives and non-executive directors on the board, board size, balance of skill and experience, refreshment of board committees and board independence – key elements of good governance. Based on the findings of the Review, this section identifies areas where the meaningfulness and quality of disclosures in the annual report could be enhanced for the benefit of investors.

i Board Balance

The Review notes that the size of the board and the balance between executive directors and non-executive directors is rarely discussed or justified in the annual report. In addition, it is difficult to discern from the corporate governance reports what skills and expertise individual directors bring to the board and how directors contribute to collective board strength. This cannot be observed from director biographies alone.

In relation to committee membership, the usual approach is to indicate by way of symbols (in the director biographies) the committees on which the directors sit. It is suggested that this does not provide sufficient insight to the readers' understanding of their contribution and/or the skills they bring to the committees.

Compliance with principle A.3 (Board balance and independence) can be particularly challenging for companies that have directors that have been appointed by shareholders or government. A distant investor reviewing a company's governance framework might not understand or appreciate the rationale or history behind shareholder/government appointments²². In relation to the issue of skill and expertise, more information could be provided on how these directors add value to the board. The biographies of shareholder nominees in particular tend to be notably vague. The Review highlights that additional effort could be made in the annual report to highlight the skills, expertise and/or contribution of these directors. This is all the more obvious when these non-executive directors do not sit on board committees and consequently committee membership is concentrated in a small group of independent non-executive directors.

ii Non-executive Director Independence

Board independence is a fundamental principle enshrined in all governance codes and should be given the utmost attention. Code provision A.3.2 requires that at least half of a company's board (excluding the Chairman) should comprise independent non-executive directors. The seven criteria for assessing the independence of non-executive directors are set out in provision A.3.1. Section 5.1 of this Report outlines the views of the listed companies on board independence.

There are times when non-executive directors, not meeting the independence criteria, will enhance the board and bring beneficial and/or essential skills to the board. However, this should be captured in the discussion in the annual report on the balance of skill and experience on the board.

Code provision A.3.1 requires that boards identify in the annual report the non-executive directors determined by the board to be independent. Where a director is posited as being independent, even though one or more of the independence criteria are not satisfied, the Code requires the board to explain why it considers a non-executive director to be independent in judgement and character. There are criteria that a distant investor can observe in relation to director independence (e.g. commercial ties, length of service on the board) and criteria that it cannot observe (e.g. behavioural aspects of boards). In the case of the latter, shareholders are relying on boards to opine on their own judgement and character. The clarity and honesty of this disclosure by companies is critically important. The Review highlights this as an area of disclosure that could be enhanced. Descriptions such as "The director continuously exhibits independence of mind" or "The director continually challenges the executive directors" might well be true but do not provide sufficient information on which investors can make an informed judgement regarding the appropriateness or otherwise of having the director on the board.

iii Board Refreshment

The Review finds that the policy on board renewal tends not to receive sufficient attention in annual reports, beyond those companies who confirm that non-executive directors on the board for more than nine years seek annual re-election and/or that all non-executive directors are subject to re-election every three years. Boards should provide investors with a clear understanding of the board's philosophy on length of service and board renewal, particularly in the context of the criteria enshrined in provision A.3.1. The process for ensuring that the board of directors meets the governance needs of the company on a continual basis could be set out more clearly in the annual report.

The Code requires that boards should justify to shareholders in the papers accompanying a resolution to elect a non-executive director why they believe an individual director should be elected. The Review suggests that the recommendations from chairmen regarding new appointments (in the annual report and/or letter accompanying the AGM Notice) could be more informative. While readers are generally referred to the biography of the director in the annual report, the inclusion of information as to the specific skills and experience the director brings to the board, and why these skills and experience are particularly relevant to the organisation, would be useful for investors.

The Code²³ requires that, when proposing a non-executive for re-election, boards confirm that, following formal performance evaluation, the individual's performance continues to be effective and to demonstrate commitment to the role. The Review suggests that a strong justification could more often be provided on why the shareholders should re-elect non-executive directors. In situations where directors have been on the board for more than six years, their continued membership should be justified, in the context of the independence implications of their tenure and the need for board and committee refreshment. The typical wording used includes "The director continues to be effective and challenge the executives on the board". Additional efforts could be made in this area to provide investors with more meaningful information.

Recommendations: The Board

The quality and meaningfulness of annual report disclosures on the board could be enhanced by providing:

R3 Board Balance

- A justification for the current board size and structure, particularly where the company is not compliant with provision A.3.2 requiring that at least half of the board should comprise non-executive directors determined by the board to be independent;
- The challenges facing the organisation, the skills and knowledge base of the board and a description of how these skills are being/will be harnessed to address the challenges identified. This description should cover, inter alia, membership of board committees and the length of service of the individual directors;
- The date of appointment of each director in the director biographies;
- For those companies with directors nominated by shareholders and/or government, the rationale or historical basis for having such nominees on the board could be included in the corporate governance report, as well as a description of the skills and expertise these directors bring to the board and how they contribute to its collective strength.

R4 Non-executive Director Independence

- For non-executive directors not meeting one or more of the Code's independence criteria (provision A.3.1), boards should explain how the director is capable of exhibiting independent judgement given the specific relational or commercial connections that apply.

R5 Board Refreshment

- The annual report should contain a commentary on the policy/strategy for board and committee renewal;
- Proposals on the re-election of non-executive directors should address the independence of the directors, if applicable (in terms of commercial and/or other connections with the company and the directors' tenure on the board), and demonstrate consistency with the company's strategy for board and committee renewal. The chairman should clearly outline to shareholders why the director continues to be the 'right person for the job';
- Recommendations from chairmen regarding new appointments (in the annual report and/or letter accompanying the AGM Notice) should clearly set out the skills that the proposed director brings to the board and why these skills are critical to the company at this time.

2 Workings of the Board

The previous section focused on disclosures pertaining to the board itself. This section deals with the operation of the board and the challenge of communicating to investors, via the annual report, how the board is discharging its obligations. The sub-division of boards into committees, while not negating the overall responsibility of the board, has become a governance norm. The three most common committees are the audit committee, the remuneration committee and the nomination committee. The Review finds that disclosure by boards on the workings of these committees within the annual report could be improved in order to deliver more meaningful information to investors.

i Work of the Audit Committee

The board is responsible for the integrity of corporate financial reporting and for overseeing the system of internal control. The audit committee, acting on behalf of the board, examines these areas in more detail than permitted during board meetings and reports back to the board. The draft revised Combined Code published by the FRC in December 2009 seeks to make the board's responsibility for risk more explicit through a new principle and provision. Boards will be required to establish formal and transparent arrangements for considering how to apply the financial corporate reporting, risk management and internal control principles. Essentially, the role of audit committees will be extended to include a responsibility for monitoring risk, unless a separate risk committee has been set up for those purposes. Appropriate and full disclosure arising from this new requirement will provide valuable information to shareholders going forward.

Provision C.3.3 requires boards to describe the work of the audit committee in discharging its responsibilities (as set out in the committee's terms of reference) in a separate section of the annual report. Boards should use this report as an evidence base for the work carried out by the audit committee. The Review finds inadequate disclosure on how audit committees actually discharge their obligations during the financial year. The common approach of companies is to replicate the duties of the audit committee as set out in the committee terms of reference document. The disclosures in this area could be enhanced by providing additional information on the depth and breadth of the committee's work.

In relation to the risks and uncertainties facing companies, this disclosure should cover the role of the audit committee in overseeing the management of these risks and uncertainties.

ii Work of the Remuneration Committee

The global financial crisis has put a focus, particularly in the financial sector, on executive remuneration firmly back on the governance agenda. The Listing Rules of the ISE²⁴ require disclosure of information on directors' remuneration. The Code contains provisions, inter alia, on the level and composition of remuneration²⁵. The discussion with listed company directors, as outlined in Chapter 5 of this Report, highlights the challenges that remuneration issues pose for boards.

The remuneration committee, acting on behalf of the board, is responsible for considering the remuneration of executive directors (and in many cases the first layer of senior management below the board) and making recommendations on remuneration policy and levels to the board. To do so, the remuneration committee must identify a remuneration philosophy or policy that captures the diversities and challenges of the company and clearly reflect this policy in the annual report. The Review finds that, in general, the remuneration policies, philosophy and strategy of companies could be made clearer in the remuneration reports.

The European Commission has recently issued guidance on the remuneration policies and related disclosures of listed companies²⁶. In addition, the European Commission has issued separate guidance on the remuneration policies of financial institutions²⁷. Listed companies that disclose in line with the disclosure provisions in paragraph 5 of Section II (Remuneration Policy) of the EU Guidance on Remuneration are likely to meet future institutional investor expectations on disclosures in the area of remuneration.

iii Work of the Nomination Committee

In an earlier section of this Report, the importance of having the right balance of skill and expertise on the board and of reflecting this in disclosures within the annual report was discussed. As will be noted in Chapter 5, a significant challenge faced by Irish boards (and/or nomination committees) is identifying non-executive directors with the right skill and expertise (and independence) to meet the needs of the board. For this reason, the process for identifying, nominating and appointing directors is of real and critical importance to shareholders. In this context it is an area that should receive more attention in the annual report.

The Code requires companies to describe the work of the nomination committee, including the process followed in relation to board appointments (provision A.4.6). The Review highlights that the general approach taken by companies is to simply summarise the duties of the nomination committee. The process behind the appointment of new directors is rarely disclosed and, when it is, it could be more informative. In addition, the use of search consultants and open advertising is rarely made clear. Where such processes are not used, justification is rarely provided, even though this is required by the Code. Clear disclosure on the process surrounding appointments to boards should be provided in annual reports.

It is clear from the discussions held with directors (see Chapter 5) that in a small market like Ireland, boards face significant challenges in identifying suitable non-executive directors, particularly with requisite expertise on public boards.

Recommendations: The Workings of the Board

Annual report disclosures on the work of board committees could be enhanced by providing:

R6 Audit Committees

- A tailored discussion of the principal risks facing the company and a reflection on how the management of these risks is being overseen by the board, through the work of the audit committee;
- A separate section of the annual report that explains clearly the work carried out by the audit committee during the financial year.

R7 Remuneration Policy

- A clear and concise disclosure on remuneration policy in line with the disclosure provisions contained in paragraph 5 of Section II (Remuneration Policy) of the EU Guidance on Remuneration (see footnote 26);
- Where there are particular challenges facing a company in attracting, retaining and motivating key personnel, the specific contextual facts leading to these challenges should be described, as well as the overall strategy for dealing with these challenges.

R8 Process for Identifying, Nominating and Appointing Directors

- A report of the process followed by Nomination Committees in identifying a pool of candidates and selecting and appointing the right candidate for each new appointee;
- Disclosure on the use of external search agencies and advertising, with a reasonable justification provided when neither is used.

3 Performance Evaluation

The Code requires boards to state in the annual report how performance evaluation of the board, its committees and its individual directors has been conducted (provision A.6.1).

With few exceptions, disclosure on the process of performance evaluation of the board is poor across the companies reviewed. The majority of companies simply reiterate what is contained in provision A.6 without providing key information on the performance evaluation process. The modus operandi of the evaluation process is rarely disclosed. Where it is, the most common description provided is: "The chairman held conversations with independent directors", which fails to provide investors with bespoke meaningful information. The important distinction between the evaluation of board process, the evaluation of individual directors and the evaluation of collective board strength could be made clearer in the annual reports.

In only two of the companies reviewed were independent consultants engaged to perform the evaluation. In other companies the process was one of self-evaluation led by the chairman and/or the senior independent director. In these cases, more effort could be made to demonstrate how director objectivity is achieved, given that the directors are, in effect, opining on their own effectiveness.

Recommendations

R9 Performance Evaluation

Annual report disclosures on performance evaluation could be enhanced by providing:

- The objective and scope of the review, the methodology applied and a justification for this methodology. Within this description, the distinction between the evaluation of board process, individual directors and collective board strength should be set out clearly;
- In circumstances where the process is one of self-evaluation, an outline of how objectivity was safeguarded within the evaluation process.

4.3 Other Issues

The Review highlighted the following points on the layout of the corporate governance report and the provision of additional information:

- 1 In some annual reports, the relevant corporate governance information was dispersed throughout the report, generally in notes to the accounts. This creates challenges for readers of annual reports, as it can be difficult to link disjointed information in order to fully comprehend the issue being discussed;
- 2 It would be useful for readers of annual reports to be directed to the location of committee terms of reference documents. The majority of companies stated that the committee terms of reference were available on the company website, but for certain companies this was not the case;
- 3 A number of corporate websites were not up to date vis-à-vis corporate governance information. In most cases the corporate governance section of company websites provided little additional information over and above that which was included in company annual reports.

FOOTNOTES – CHAPTER 4

- 16 Uninformative explanation captures those circumstances where the explanation is either not informative or has not been provided. Notably, however, in the majority of circumstances (12/22) where no explanation is provided for not complying with a specific Code provision, corrective action (proposed or taken) is outlined.
- 17 Boiler-plate explanations are standardised or un-customised, often taken directly from the Code and do not address the specific company circumstance or context to enable shareholders understand why the provisions of the Code have not been complied with.
- 18 Adequate explanations address the specific company circumstances or context to enable shareholders understand why the provisions of the Code have not been complied with.
- 19 This category refers to those provisions cited only once across the 29 companies. In four cases the companies did not need to provide explanations as they are actually compliant. The results have therefore been included in the 'Adequate Explanation' category.
- 20 Financial Reporting Council (2009), Consultation on the Revised UK Corporate Governance Code, Financial Reporting Council, United Kingdom, paragraph 7 of the Chairman's Preface sets out that "personal reporting on governance by chairmen as leaders of boards might be a turning point in attacking the fungus of 'boiler-plate' which is so often the preferred and easy option in sensitive areas but which is dead communication".
- 21 Main and supporting principle (A.3) and Code provisions A.3.1 to A.3.3.
- 22 Eight of the 29 companies reviewed have directors on the board nominated by shareholders and/or government.
- 23 Code provision A.7.2.
- 24 Listing Rule 6.8.5.
- 25 Combined Code: Section B 'Remuneration'; and Schedule A 'Provisions on the design of performance related remuneration'.
- 26 The EU Guidance on Remuneration of directors of listed companies is available at the following web address: http://ec.europa.eu/internal_market/company/docs/directors-remun/directorspay_290409_en.pdf.
- 27 The European Commission Recommendation on remuneration policies in the financial services sector is available at the following web address: http://ec.europa.eu/internal_market/company/docs/directors-remun/financialsector_290409_en.pdf.

Chapter 5

The Director Perspective

As part of the Review process, discussions were held with four company directors from the Sample Group²⁸, the purpose of which was to gain an understanding of their views on governance practices in Ireland, and specifically the issues set out in section 2.3 of this Report. It should be noted that the views expressed by the directors of the Sample Group do not represent those of the 29 listed companies.

This chapter outlines the key issues emanating from this discussion group in the context of observations and recommendations contained in Chapter 4.

5.1 Compliance with the Combined Code 2006

STATEMENT OF COMPLIANCE

The consensus among participants is that significant emphasis and importance is placed on corporate governance frameworks by boards of directors of Irish listed companies. The participants, all of whom were non-executive directors, suggest that the Code is an enabling structure for non-executive directors. In general, it is not difficult to get the buy-in of executive directors to good standards of corporate governance. Boards understand that they are under a stakeholder lens at all times, (investors, regulators, analysts and the financial press) and consider the Code as providing a framework within which boards can operate from a governance perspective – a benchmark against which organisations can judge themselves. It is acknowledged that boards, as a whole, support the code-based approach to corporate governance and value the ‘comply or explain’ approach.

While a monetary value cannot be attributed to the strength or otherwise of a company’s governance regime, participants are confident that the institutional investor community has better regard for companies with a stronger regime. High standards of governance inspire confidence in how the organisation is directed and controlled and, as such, in the sustainability of the organisation. Participants were keen to point out the role of the board in ensuring that the tenets of corporate governance are embedded at every level of the organisation. The board must set the culture within the organisation by going about its business in a transparent, ethical and accountable manner. It is important that executives within the organisation understand both the governance framework and the implications of governance failure.

In the participants’ experience, many institutional investors have active governance departments that engage with boards on significant/contextually relevant governance issues. It was clear from discussions that active dialogue takes place between Irish boards and institutional shareholders on an ongoing basis. Participants find the objective and knowledgeable approach of institutional investors on governance issues very helpful and informative.

APPLICATION OF THE PRINCIPLES OF THE CODE

In relation to compliance with the Code, participants identified a number of challenges:

Board Independence

The most significant challenge identified by participants is in relation to board independence, i.e. having enough independent directors to balance the executive management team. Participants suggested that the requirements for independence are quite stringent and restrictive, presenting particular challenges for a small country such as Ireland. All the participants agree strongly with the principle of director independence, but not necessarily with certain of the Code's independence criteria. The criteria relating to tenure on boards was one that participants particularly struggle with. They pointed out that independence is a personal trait that cannot be legislated or prescribed. Directors that are theoretically independent may be less independent in judgement and character than those who do not meet the independence criteria.

Director Selection and Re-election

Another significant challenge is identifying non-executive directors with the right skill and expertise (and independence) to sit on boards. It was noted that, in a small country such as Ireland, the pool of candidates is limited. Directors must bring, inter alia, commercial experience to the board and contribute to the strategic direction of the organisation. It is costly for a company to appoint the 'wrong' director. The challenge is building a group of individuals with the right mindset, right values – creating a team of people who want to, and are capable of, working together. It was agreed generally that it would be beneficial to have more transparency around how directors are appointed.

Executive Remuneration

The greatest challenge for remuneration committees is getting the balance right between the expectations of shareholders and those of executive management regarding remuneration. Shareholders want to see changes to how executives are incentivised, but executives have to be motivated to work in a pressured or intense environment. The 2009 FRC Review recommends a number of additional requirements in the area of executive remuneration. A suggested amendment is for consideration to be given to the use of provisions that permit companies to reclaim variable components of pay in exceptional circumstances of misstatement and misconduct. This 'claw back' concept raises a number of complex areas of judgement for directors, particularly as application of this provision will vary from situation to situation. Another suggested amendment to the Code relates to the compatibility of remuneration incentives with the company's risk policies and systems. Boards are concerned with how to incorporate risk into the remuneration process in practice – the difficulty in assessing performance for a given level of acceptable risk.

5.2 Application of the Code Principles: Quality of Corporate Governance Disclosures

STANDARDISED DESCRIPTIONS/EXPLANATIONS

Several points were raised by participants in relation to disclosure. While boards have no difficulty embracing, where possible, changes to the Code which apply to all listed companies, they would be concerned from a competitive viewpoint if they become subject to disclosure requirements which their competitors are not required to comply with. However, they acknowledged that there is a collective benefit to all companies doing 'the right thing' and from an 'Ireland Inc' perspective being as transparent as possible.

MAIN AREAS FOR IMPROVING DESCRIPTIONS

There was general agreement among participants that executive remuneration is the trickiest governance issue as regards disclosure. The likelihood of a push for even further disclosure in this area was noted. This raises a number of concerns. Firstly, sensitive information becomes available to competitor firms who may be interested in poaching senior executives. Secondly, there is the difficulty of reflecting the complexity of the remuneration setting process within the remuneration report. The role of the remuneration committee is to attract and retain key personnel while meeting the expectations of shareholders. The trend towards more granular disclosure of remuneration elements, thresholds and criteria should not go as far as to devalue or replace the element of independent judgement that non-executive members of the remuneration committee are expected to deliver.

Participants cited remuneration as an area on which significant dialogue takes place between boards and institutional investors (US investors in particular). Institutional investors are interested in companies' remuneration policies, e.g. boards' strategy on fixed versus variable pay and consistency between corporate objectives and desired risk profiles and remuneration policy. New long-term incentive plans (LTIPs) are discussed extensively between the chairman/senior independent director and institutional investors before approval for the LTIP is sought from shareholders. Participants consider that the area of remuneration will be under even more scrutiny in the future.

Another area cited by participants as generating much debate with institutional investors is the way in which directors are elected and how the votes are calculated. US investors, in particular, want to see a clear majority of shareholders (rather than a majority of those who vote) approving appointments. This reflects the significance placed by institutional investors on board appointments.

5.3 Quality of Explanations for Non-compliance with the Code

The consensus amongst participants is that the mindset of most companies is based around compliance with the Code. That said, issues might arise where full compliance with the Code is not in the commercial interest of the company. This is the benefit of the 'comply or explain' approach to regulation. In such circumstances, participants agreed that a meaningful explanation for non-compliance should be provided.

5.4 Conclusion

The feedback from the discussion group underscores the practical challenges involved in meeting the standards set by the Code. Interestingly, the issues raised by the directors are in line with those identified in the FRC's final report on the Review of the Combined Code (see footnote 6).

FOOTNOTE – CHAPTER 5

- 28** Six companies from the Sample Group were asked to nominate one director to participate in the discussion group. Four companies agreed to participate. The directors included a non-executive chairman and three non-executive directors from Irish companies listed on the ISE. The discussions were facilitated by the independent researcher.

Chapter 6

The Irish Investor Perspective

In parallel with the Review process, discussions were held with Irish institutional investors²⁹ (the 'Discussion Group') to identify and reflect the views of institutional investors on corporate governance practices in Ireland. The following issues were discussed with the participants:

- 1 Changing environment;
- 2 Corporate governance practices in Ireland;
- 3 Effectiveness of the Combined Code approach;
- 4 Importance of disclosure in annual reports; and
- 5 Emerging areas of emphasis.

This chapter outlines the key observations and issues arising from these discussions.

6.1 Changing Environment

Feedback from the Discussion Group suggests that the events of the past two years have presented the boards and executive management of all listed companies with significant business and strategic challenges. The crisis in financial markets has seen a contraction of credit, re-pricing of risk and new attitudes to equity, each of which impacts the future funding of corporates. Globally, including in Ireland, allocations to equities by large institutional pension fund clients have reduced and are likely to remain at lower levels. Sectoral and geographic allocations have also changed. Allocations to Irish equities within the mandates of Irish investment managers have fallen and this trend can be expected to continue to a new lower enduring level by 2011.

6.2 Corporate Governance Practices in Ireland

The Discussion Group made the following observations on corporate governance practices in Ireland:

- Listed companies with strong governance structures achieve, over time, a premium to their peers;
- The trend amongst large institutional clients of investment firms to seek evidence of governance engagements on their behalf has accelerated significantly;
- During 2008 and particularly in 2009 the international perception of governance standards in Ireland has been damaged. This general perception is unwarranted in the case of many Irish listed companies. Nonetheless, damage, even if perceived, must be repaired;
- Shareholders form only part of the corporate governance equation for listed companies. The control of and responsibility for the management and operation of listed companies is in the hands of their boards. Shareholder voting and constructive engagement between shareholders and boards are key elements of good governance; and
- The achievement of good governance through compliance with the Code is dependent foremost upon the quality of the board. There needs to be strong independence characteristics, a diversity of skills relevant to the challenges of the business, appropriate chairs of board committees and a suitable chairman and senior independent director. In addition, there should be a commitment to regular renewal of the board and to the planning for succession within the board.

6.3 Effectiveness of the Combined Code Approach

The Discussion Group acknowledges that the delivery of good governance differs for each business and depends on the nature of the business, the particular risks it faces, its strategy, the markets in which it operates and a myriad of other factors. For this reason, such fundamental differences between businesses do not lend themselves to an effective statute or rules based governance regime. The Discussion Group, therefore, views the Code as the most effective guide to the delivery of good governance. Institutional investors endorse the ‘comply or explain’ approach, provided it is rigorously implemented.

6.4 Importance of Disclosure in Annual Reports

The principal ongoing conduit by which listed companies can convey their commitment to governance is the annual report. The Discussion Group highlighted the importance for annual reports to contain vibrant disclosure on how the Code is applied. While many companies undoubtedly have good governance cultures, this is often not reflected by disclosure (in particular to non-domestic investors who may be less familiar with the company) and is diminished by the use of ‘boiler-plate’ disclosures.

6.5 Emerging Areas of Emphasis

As investors and their clients, regulators and indeed governments elevate the importance of governance issues, the Discussion Group considers that the following areas are likely to come under close scrutiny by investors in 2010 and beyond:

- The introduction of ‘say on pay’ votes on a non-binding basis at annual general meetings and the willingness of institutional investors to table such resolutions, if necessary;
- An enunciation of the skill sets brought to the board by the sitting NEDs and the rationale for their appointment to particular board committees;
- A commentary on the policy for board renewal and on the independence of NEDs;
- A tailored discussion of the principal risks facing the business and a reflection on how these are dealt with both at board and board committee level;
- More detail than is currently the norm on the processes by which the performance of NEDs and the chairman are evaluated;
- An explanation in the annual report of how compliance with EU Guidance on Remuneration in Listed Companies is achieved; and
- Where non-compliance is being explained a comprehensive company specific rationale for that non-compliance.

6.6 Conclusion

As companies seek to broaden their shareholder base, or indeed to retain some existing long shareholders, it is important that boards do not underestimate the role of governance considerations. In the case of many of the large global investment managers a governance review is now a prerequisite to any investment decision.

FOOTNOTE – CHAPTER 6

- 29 Discussions were held with senior representatives from 8 of the 14 members of the IAİM. In total, IAİM members have €6 billion invested in Irish equities.

Appendix 1

Companies Reviewed

Aer Lingus Group plc

Allied Irish Banks plc

Aminex plc

Bank of Ireland plc

C&C Group plc

CRH plc

Datalex plc

DCC plc

Dragon Oil plc

ELAN Corporation plc

FBD Holdings plc

Glanbia plc

Grafton Group plc

Greencore Group plc

Icon plc

IFG Group plc

Independent News & Media plc

Irish Continental Group plc

Irish Life & Permanent plc

Kenmare Resources plc

Kerry Group plc

Kingspan Group plc

McInerney Holdings plc

Oglesby & Butler plc

Paddy Power plc

Readymix plc

Ryanair Holdings plc

Smurfit Kappa Group plc

United Drug plc

Appendix 2

Summary of Recommendations

The Table below summarises the main recommendations for consideration by boards in the future arising from the Review. Chapter 4 outlines the main observations arising from the Review and provides a background to these recommendations.

R1 Explanations for Divergence from Code Provisions

Companies seeking to move away from 'boiler-plate' language when providing explanations under the Code should consider the following points:

- Explanations should clearly reflect the contextual environment within which the company is operating;
- An indication of how and when the company will be in a position to return to compliance with the relevant provision(s) should be disclosed;
- In circumstances where the company considers that non-compliance with a particular provision is in the best interests of the company, a robust justification for this opinion should be provided.

R2 Standardised Descriptions

- Companies should avoid adopting wording verbatim from the Code and instead should outline in their annual report in a bespoke manner how the principles are actually applied. The description provided should clearly reflect the contextual environment within which companies are operating.

The Board

The quality and meaningfulness of annual report disclosures on the board could be enhanced by providing:

R3 Board Balance

- A justification for the current board size and structure, particularly where the company is not compliant with provision A.3.2 requiring that at least half of the board should comprise non-executive directors determined by the board to be independent;
- The challenges facing the organisation, the skills and knowledge base of the board and a description of how these skills are being/will be harnessed to address the challenges identified. This description should cover, inter alia, membership of board committees and the length of service of the individual directors;
- The date of appointment of each director in the director biographies;
- For those companies with directors nominated by shareholders and/or government, the rationale or historical basis for having such nominees on the board could be included in the corporate governance report, as well as a description of the skills and expertise these directors bring to the board and how they contribute to its collective strength.

R4 Non-executive Director Independence

- For non-executive directors not meeting one or more of the Code's independence criteria (provision A.3.1), boards should explain how the director is capable of exhibiting independent judgement given the specific relational or commercial connections that apply.

R5 Board Refreshment

- The annual report should contain a commentary on the policy/strategy for board and committee renewal;
- Proposals on the re-election of non-executive directors should address the independence of the directors, if applicable (in terms of commercial and/or other connections with the company and the directors' tenure on the board), and demonstrate consistency with the company's strategy for board and committee renewal. The chairman should clearly outline to shareholders why the director continues to be the 'right person for the job';
- Recommendations from chairmen regarding new appointments (in the annual report and/or letter accompanying the AGM Notice) should clearly set out the skills that the proposed director brings to the board and why these skills are critical to the company at this time.

The Workings of the Board

Annual report disclosures on the work of board committees could be enhanced by providing:

R6 Audit Committees

- A tailored discussion of the principal risks facing the company and a reflection on how the management of these risks is being overseen by the board, through the work of the audit committee;
- A separate section of the annual report that explains clearly the work carried out by the audit committee during the financial year.

R7 Remuneration Policy

- A clear and concise disclosure on remuneration policy in line with the disclosure provisions contained in paragraph 5 of Section II (Remuneration Policy) of the EU Guidance on Remuneration;
- Where there are particular challenges facing a company in attracting, retaining and motivating key personnel, the specific contextual facts leading to these challenges should be described, as well as the overall strategy for dealing with these challenges.

R8 Process for Identifying, Nominating and Appointing Directors

- A report of the process followed by Nomination Committees in identifying a pool of candidates and selecting and appointing the right candidate for each new appointee;
- Disclosure on the use of external search agencies and advertising, with a reasonable justification provided when neither is used.

R9 Performance Evaluation

Annual report disclosures on performance evaluation could be enhanced by providing:

- The objective and scope of the review, the methodology applied and a justification for this methodology. Within this description, the distinction between the evaluation of board process, individual directors and collective board strength should be set out clearly;
- In circumstances where the process is one of self-evaluation, an outline of how objectivity was safeguarded within the evaluation process.

'This Report provides valuable insights into corporate governance practice in the listed sector. Great credit is due to the ISE and the IAIM for taking this initiative and to the Review Group for overseeing a meaningful and timely review. The recommendations should support companies in their efforts to meet emerging investor expectations on their governance practices and reporting.'

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