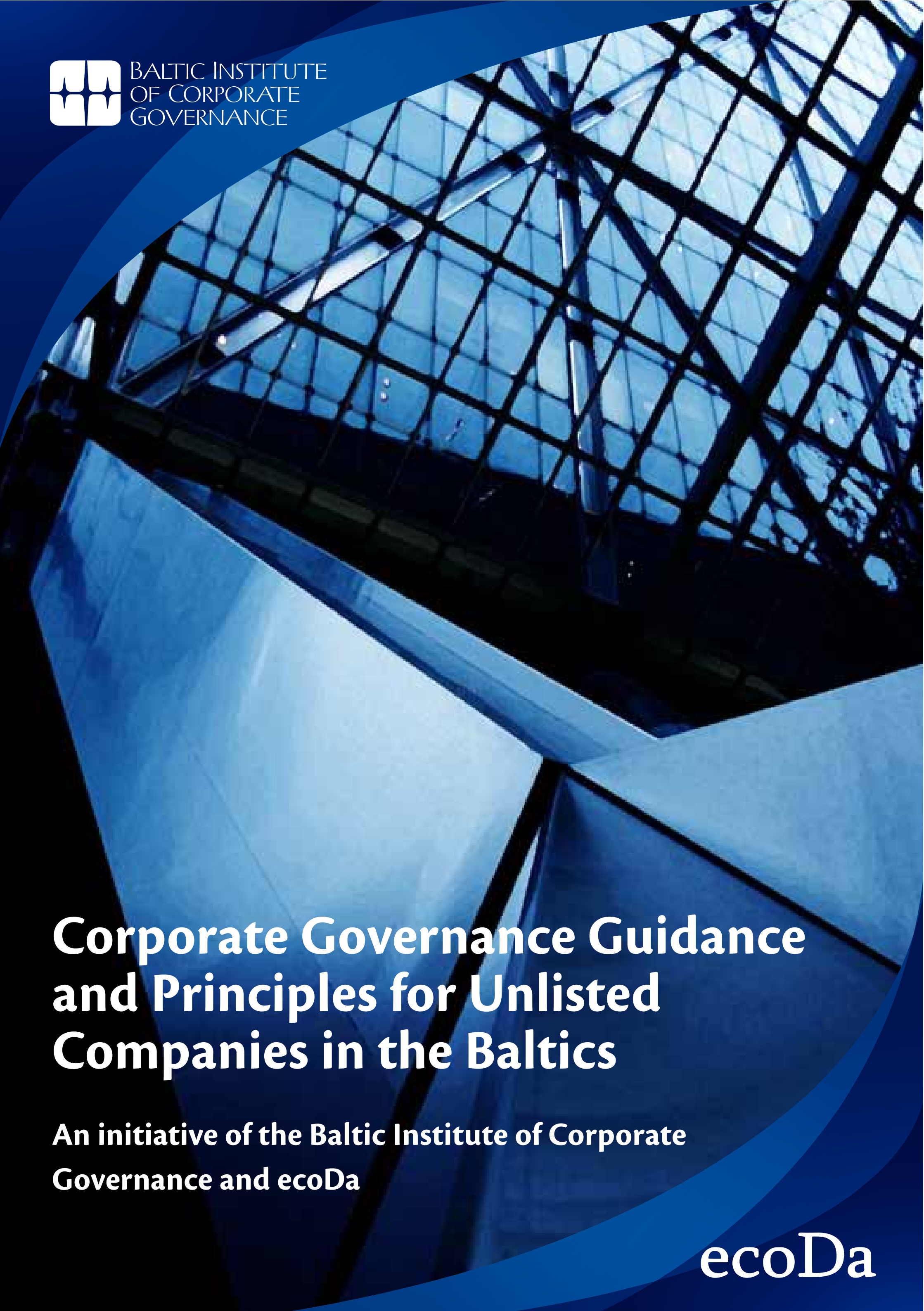

Baltic Institute of Corporate Governance

Corporate Governance Guidance and Principles for Unlisted Companies in the Baltics

An initiative of the Baltic Institute of Corporate Governance and ecoDa

ecoDa

This document is a practical tool for the shareholders, directors and stakeholders of unlisted companies.

The original pan-European edition of the guidance - Corporate Governance Guidance and Principles for Unlisted Companies in Europe - was published by the European Confederation of Directors' Associations (ecoDa) in March 2010. It was developed by an ecoDa working group chaired by Prof. Dr. Lutgart Van den Berghe, Chairwoman of ecoDa's Policy Committee and Executive Director of GUBERNA (Belgium).

The working group also included:

- Juan Álvarez-Vijande, Chairman of ecoDa and Executive Director of IC-A (Spain);
- Dr. Roger Barker, Head of Corporate Governance at the IoD (UK);
- Philippe Decleire, Chairman of ecoDa's membership committee and Treasurer;
- Jean-Philippe Drescher, Chairman of ILA's Financial Companies' Committee (Luxembourg);
- Pascal Viénot, Affiliated Professor and Director of Governance programs at HEC Executive Education, Senior Partner of "Associés en Gouvernance" consulting firm, Rapporteur of IFA's mid-sized companies' commission (France);
- Irena Prijovic, ecoDa board member and Secretary General of ZNS (Slovenia);
- Béatrice Richez-Baum, Secretary General of ecoDa;
- Olli V. Virtanen, ecoDa Board Member, Chairman of ecoDa's Sponsorship and External Communication Committee and Secretary General of Hallitusammattilaiset ry (Finland);
- Axelle Wibault, Junior Coordinator and Researcher, GUBERNA (Belgium).

ecoDa is particularly grateful to Prof. Dr. Lutgart Van den Berghe and Dr. Roger Barker, both of whom made significant contributions to the drafting of the pan-European version of the document.

A UK edition has been adapted for the UK business environment by Dr. Roger Barker, Head of Corporate Governance at the IoD & published in November 2010.

This Baltic edition has been adapted by the Baltic Institute of Corporate Governance (BICG).

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About the Baltic Institute of Corporate Governance

The Baltic Institute of Corporate Governance (BICG) is a not-for-profit, non-governmental association with strong involvement from Baltic business and political leaders.

The BICG is leading the way in Baltic corporate governance by helping to create better governed public and private companies.

The BICG as an association is governed by its members. The relationship between the Association's members, the Board, the Council, management and other stakeholders is regulated in the bylaws of the Association.

The BICG is proud to be a regional affiliate of the Global Corporate Governance Forum www.gcgf.org as well as a member of ecoDa, the European Confederation of Directors' Associations www.ecoda.org

About ecoDa

ecoDa, the European Confederation of Directors' Associations, is a not-for-profit association acting as the European voice of board directors, active since March 2005 and based in Brussels. On behalf of its 11 national institutes of directors, ecoDa ensures that their views on corporate governance are clearly communicated to policymakers in the EU institutions. ecoDa acts as a high-level forum for debate and for the exchange of experiences to promote high standards for directors in Europe. It acts as a standing body where national experiences are shared and discussed in detail. www.ecoda.org

Quotes about the Baltic, UK and European editions

”Unlisted companies make a major contribution to economic growth and employment in all European countries. However, the corporate governance needs of such companies have until recently been relatively neglected by governance experts and policy-makers. This publication will assist unlisted Baltic companies in the design and implementation of an appropriate corporate governance framework. Baltic companies will benefit from its practical approach and its reflection of the distinctive context of the Baltic business environment.”

Dr. Roger Barker, Head of Corporate Governance, Institute of Directors, London

As investors, we see good corporate governance as well as environmentally and socially responsible behavior as essential in managing any company with the aim of maximizing long-term shareholder value. In our investment region, improving corporate governance is an important and obvious first step for companies in their efforts to attract investors. Companies which are managed along clear and credible principles that align shareholder interests; with an independent board and transparent financial reporting are clearly better positioned to enhance investor confidence and thereby increase investor interest. This publication is an excellent guide to unlisted companies in the Baltics wanting to implement a governance framework based on international best practice.

Louise Hedberg, Head of Corporate Governance, East Capital AB

For decades capital market experts have beavered to develop governance advice meant to produce healthy listed companies that last, create jobs and contribute to prosperity. However, much of the wealth generated in economies comes not from companies on stock markets, but from unlisted enterprises. We want those too to be strong and sustainable. Now comes this timely set of principles, which offers important, practical and useable guidance to corporations, managers and investors. It also gives other stakeholders—employees, public officials and civil society organizations—a tool to test whether unlisted companies are best configured to survive and prosper.

Stephen Davis, Ph.D., Executive Director Millstein Center for Corporate Governance & Performance, Yale School of Management

“The global financial crisis has reminded us that it’s nearly impossible to find a “silver bullet” in the form of laws and regulations to improve board performance. That leaves the private sector with a major responsibility to improve board practices through, inter alia, implementing voluntary standards. This is particularly the case in unlisted companies, where the long-term success of the company, including its strategy depends on an effective board.”

Fianna Jesover, Senior Policy Manager, Corporate Affairs Division, OECD, Paris

Foreword by the President

Of the registered companies in the Baltics, the overwhelming majority are SMEs or start-up companies that remain under the ownership and control of the founder or founding family/group.

Such unlisted enterprises are the backbone of the Baltic economies. They account for upwards of 70% of the GDP and employment. Furthermore, they are a key source of dynamism and entrepreneurial spirit. Their potential contribution to any economic growth should not be underestimated.

The financial crisis has provided a stark reminder of the need for a robust governance framework in the global banking sector. However, good governance is not only relevant for financial institutions and large listed companies. The BICG is convinced that appropriate corporate governance practices can contribute to the success of Baltic companies of all types and sizes, including those that are unlisted or privately held.

In this document, fourteen principles of good governance for unlisted companies are presented on the basis of a dynamic phased approach. This takes into account the size, complexity and level of maturity of individual enterprises. Unlisted companies – such as founder and family-owned businesses – can utilise this stepwise framework to ensure their long-term sustainability, to bring external parties to their boards, to attract funds, and to solve issues between shareholders and other stakeholders.

Although only applicable on a voluntary basis, the Principles and Guidance included in this document provide practical advice for unlisted Baltic companies that wish to establish an effective and value-adding governance framework at each stage of their development process.

This initiative has been made possible thanks to strong support from the individual and corporate members of the BICG, especially DnB Nord Bank and the Board and Council members of the BICG as well as the pioneering work of ecoDa, which developed the original European text from which this Baltic edition has been adapted.

Finally a big thank you to Dr. Roger Barker from the IOD, Arminta Saladžienė the Chairman of BICG and Robertas Degesys from Baltic Legal Solutions for their contributions to this Baltic edition.

Kristian Kaas Mortensen

President
Baltic Institute of Corporate Governance

Corporate Governance Guidance and Principles for Unlisted Companies in the Baltics

An initiative of the Baltic Institute of Corporate Governance and ecoDa

Executive summary

- This BICG and ecoDa initiative offers a corporate governance agenda for unlisted companies in the Baltics.

- Unlisted companies make a major contribution to Baltic economic growth and employment. However, the corporate governance needs of unlisted companies have, to date, been relatively neglected by governance experts as well as by policy-makers. In particular, the Estonian, Latvian and Lithuanian Corporate Governance Codes are primarily aimed at listed rather than unlisted enterprises.

- Many unlisted enterprises are owned and controlled by single individuals or families. Good corporate governance in this context is not primarily concerned with the relationship between boards and external shareholders (as in listed companies) nor with a focus on compliance with formal rules and regulations. Rather, it is about establishing a framework of company processes and attitudes that add value to the business, help build its reputation and ensure its long-term continuity and success.

- Good corporate governance is particularly important to the shareholders of unlisted companies. In most cases, such shareholders have limited ability to sell their ownership stakes, and are therefore committed to staying with the company for the medium to long term. This increases their dependence on good governance.

- Good governance can also play a crucial role in gaining the respect of key external stakeholders. In an environment of mounting societal scrutiny towards the business world, even unlisted companies will have to take account of their corporate responsibilities towards their stakeholders. Corporate reputation will benefit from a gradually increasing transparency and accountability.

- An effective governance framework defines roles, responsibilities and an agreed distribution of power amongst shareholders, the board, management and other stakeholders. Especially in smaller companies, it is important to recognise that the company is not an extension of the personal property of the owner.

- This briefing provides guidance for unlisted companies on the issues involved in designing an appropriate corporate governance framework. It also presents a set of governance principles that can be followed or not. This remains a voluntary decision of each unlisted company.

- Fourteen principles of good governance are presented on the basis of a dynamic phased approach, which takes into account the degree of openness, size, complexity and level of maturity of individual enterprises. A dynamic approach towards governance is essential, since governance frameworks must evolve over the life cycle of a business firm.

- A key step in the development of unlisted company governance is the decision to invite external directors onto the board. Its effect on boardroom behaviour and culture should not be underestimated.

- The principles provide a governance roadmap for family owners or founder-entrepreneurs as they plan the development of their companies over the corporate life cycle. These principles may be relevant for subsidiary companies and joint ventures as well.

Phase 1 principles:
Corporate governance principles applicable to all unlisted companies

Principle 1: Shareholders should establish an appropriate constitutional and governance framework for the company.

Principle 2: Every company should strive to establish an effective board, which is collectively responsible for the long-term success of the company, including the definition of the corporate strategy. However, an interim step on the road to an effective (and independent) board may be the creation of an advisory board.

Principle 3: The size and composition of the board should reflect the scale and complexity of the company's activities.

Principle 4: The board should meet sufficiently regularly to discharge its duties, and be supplied in a timely manner with appropriate information.

Principle 5: Levels of remuneration should be sufficient to attract, retain, and motivate executives and non-executives of the quality required to run the company successfully.

Principle 6: The board is responsible for risk oversight and should maintain a sound system of internal control to safeguard shareholders' investment and the company's assets.

Principle 7: There should be a dialogue between the board and the shareholders based on the mutual understanding of objectives. The board as a whole has responsibility for ensuring that a satisfactory dialogue with shareholders takes place. The board should not forget that all shareholders have to be treated equally.

Principle 8: All directors should receive induction on joining the board and should regularly update and refresh their skills and knowledge.

Principle 9: Family-controlled companies should establish family governance mechanisms that promote coordination and mutual understanding amongst family members, as well as organise the relationship between family governance and corporate governance.

Phase 2 principles:

Corporate governance principles applicable to large and/or more complex unlisted companies

Principle 10: There should be a clear division of responsibilities at the head of the company between the running of the board and the running of the company's business. No one individual should have unfettered powers of decision.

Principle 11: All boards should contain directors with a sufficient mix of competencies and experiences. No single person (or small group of individuals) should dominate the board's decision-making.

Principle 12: The board should establish appropriate board committees in order to allow a more effective discharge of its duties.

Principle 13: The board should undertake a periodic appraisal of its own performance and that of each individual director.

Principle 14: The board should present a balanced and understandable assessment of the company's position and prospects for external stakeholders, and establish a suitable programme of stakeholder engagement.

Corporate Governance Guidance and Principles for Unlisted Companies in the Baltics

This publication is the Baltic edition of pan-European guidance developed by the European Confederation of Directors' Associations (ecoDa). It has been adapted to the Baltic business context by the Baltic Institute of Corporate Governance (BICG).

The following pages provide guidance and a set of **voluntary** "best practice" principles for Baltic companies, drawing on both the content of existing national and international corporate governance codes and the experience of good governance in individual unlisted enterprises.

The **guidance** is contained in **Part I** of the document, and is split into five main sections. The first two sections present the rationale for the publication of a set of corporate governance guidance and principles for unlisted companies. Sections 3 and 4 provide a glossary of the relevant governance actors and concepts that should be incorporated into a viable corporate governance framework. Section 5 considers some of the challenges involved in the implementation of good corporate governance.

The statement of the 14 corporate governance **principles** for unlisted companies is undertaken in **Part II**. Those readers that are already well versed in corporate governance concepts may wish to turn directly to Part II, in order to focus on the measures that can be directly applied at the level of each company.

Part I – Guidance on corporate governance for unlisted companies

The OECD defines corporate governance as follows:

"Corporate governance involves a set of relationships between a company's management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined. Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interests of the company and its shareholders and should facilitate effective monitoring"[1].

1) Why focus on unlisted companies?

The purpose of corporate governance is to facilitate effective and prudent management that can deliver the long-term success of the company.

The focus of the following corporate governance guidance and principles is on unlisted companies, i.e. limited companies that are not listed or quoted on public equity markets[2]. The scope of unlisted companies is very wide and encompasses start-ups, single owner-manager companies, family businesses, private equity-owned companies, joint ventures, and subsidiary companies.

Unlisted companies are of particular importance in countries with less developed capital markets such as the Baltic States, where the vast majority of companies are not listed on a stock exchange or regulated market. In the Baltics most small and medium-sized enterprises are not publicly listed on regulated equity markets. Furthermore, there exist many notable large corporations that have chosen – for a variety of reasons – to forgo a public listing.

According to the OECD, improved corporate governance amongst unlisted companies has the potential to significantly boost productivity growth and job creation[3]. However, despite their large numbers and economic importance, the governance of unlisted companies is an often neglected area of corporate governance studies and recommendations.

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1 *OECD Principles of Corporate Governance,* 2nd Edition, 2004, page 11.

2 The key difference between unlisted and listed companies is that unlisted companies are not issuing shares to the public. Consequently, their shares are not traded on public equity markets. They may also impose restrictions on the transferability of their shares.

3 Vermeulen (2006), page 93.

In recent years, many countries have adopted corporate governance codes[4]. In the Baltics, national corporate governance codes for listed companies are published by the operators of the regulated markets in Estonia, Latvia and Lithuania[5]. Since 2007 all Baltic listed companies annually report on their adherence with these corporate governance codes on a "comply or explain" basis[6]. To address the specific challenges of state and municipality-owned enterprises, the Baltic Guidance on the Governance of Government-owned Enterprises was published by the BICG in 2010.

However, the official codes primarily relate to listed companies. In the absence of their own specific reference point, there is a danger that unlisted companies will refrain from developing an appropriate governance framework, with negative implications for their long-term effectiveness and success. Copying the widely-recognised principles of best practice for listed companies is also not a viable solution, as the corporate governance challenges of listed companies are distinct from those of unlisted companies.

Listed companies often have large numbers of external minority shareholders, and may be run by professional managers without ownership stakes. The governance framework of such companies tends to focus on ensuring that external shareholders can exercise effective oversight and control over management and the board of directors. This is often a challenge due to the remoteness of most external shareholders from company decision-making (the so-called "principal-agent" problem), and the difficulties involved in coordinating the actions of a diffuse body of small shareholders vis-à-vis management (the so-called "collective action" problem).

In contrast, most unlisted enterprises are owned and controlled by single individuals or coalitions of company insiders (e.g. a family). In many cases, owners continue to play a significant direct role in management. Good governance in this context is not a question of protecting the interests of absentee shareholders. Rather, it is concerned with establishing a framework of company processes and attitudes that add value to the business and help ensure its long-term continuity and success.

4 The first ever corporate governance code was published in 1978 in the United States. By 2008, 64 countries had issued at least one code of governance. At an international level, the *OECD Principles of Corporate Governance* (first published in 1999 and re-issued in 2004) have proved highly influential in shaping national governance agendas.

5 Specifically, "Corporate Governance Recommendations" by NASDAQ OMX Tallinn in Estonia, "Principles of Corporate Governance and Recommendations on their Implementation" by NASDAQ OMX Riga in Latvia, and "The Corporate Governance Code for the Companies Listed on NASDAQ OMX Vilnius" by NASDAQ OMX Vilnius in Lithuania.

6 This approach means that a company choosing to depart from a corporate governance code has to explain which parts of the corporate governance code it has departed from and the reasons for doing so. *Green Paper on the EU corporate governance framework*, 4 April 2011, page 2.

In many respects, unlisted companies face a greater corporate governance challenge than listed companies. Much of the governance framework of listed companies may be externally imposed by various types of regulation and formal listing requirements. In contrast, unlisted companies have greater scope to define (or not define!) their own governance strategy. This means that unlisted companies must themselves reflect on the potential costs and benefits of various governance approaches.

Furthermore, in contrast to larger listed enterprises, smaller unlisted entities may not have access to in-house support (e.g. legal advisers or company secretarial resources) to assist them in making important decisions about governance. Determination of the governance framework will largely be a matter for the shareholders and directors, who may need extra specialist governance expertise, relevant reference frameworks as well as tools to assist them in realising the ambition of professional governance.

These considerations have persuaded the BICG and other European directors' associations that there is much to be gained from highlighting the specific governance issues of unlisted enterprises, and outlining best practice solutions in the form of a set of voluntary corporate governance principles.

2) Why corporate governance matters to unlisted companies

According to the OECD[7], a corporate governance framework consists of three main elements:

- A set of relationships between a company's management, its board, its shareholders and other stakeholders.
- A structure through which the objectives of the company are set and the means of attaining those objectives and monitoring performance are determined.
- Proper incentives for the board and management to pursue objectives that are in the interests of the company and its shareholders.

The establishment of an effective governance framework that defines the firm's approach to each of these issues is of equal importance to listed and unlisted companies. However, there are a number of reasons why unlisted companies should specifically concern themselves with corporate governance.

7 *OECD Principles of Corporate Governance* (2004), page 11.

I) Performance and internal efficiency

Corporate governance is ultimately concerned with the decision-making processes, procedures, and attitudes that assist the company in achieving its objectives. It is the framework within which decisions are made and power exercised. Consequently, as the firm seeks to improve the professionalism and sustainability of its activities, it needs to give greater thought to issues of governance.

This is a particular need if the firm wishes to shift away from dependence on the unique contribution of the founding entrepreneur. Although the ability and dynamism of one individual may have been instrumental in establishing the enterprise, this is unlikely to be sustainable in the longer term. As the enterprise grows in size and maturity – or outlives the interest or working life of the founder – governance processes must be established to ensure continuity and success beyond the efforts of one person.

Indeed, the development of effective governance processes may lift a significant burden from the founder, facilitate a swift succession and allow access to a wider pool of expertise and know-how. The result may be improved leadership, decision-making and strategic vision. Improved governance may also make it easier to monitor and manage the various risks to which the company is exposed, particularly as it grows in size and complexity.

Governance will also become an increasing issue for unlisted companies as they develop new sources of finance. Initially, the primary source of funds is likely to be retained earnings or financing from internal networks, e.g. families or associated corporate groups. However, unlisted companies may also turn to banks, venture capitalists, and private equity investors in order to finance their expansion and growth.

A greater reliance on such external sources of finance will necessitate the implementation of a more explicit governance framework, as external financiers seek assurance that their investments will be well managed.

In particular, the involvement of additional owners in the company – even if the founder retains a controlling stake – will require governance mechanisms to resolve differences between shareholders with potentially diverging agendas.

A governance structure that sustains the confidence of internal and external sources of finance – such as shareholders, banks and other creditors – will contribute to the long-term success of the firm by securing the commitment of patient capital partners. The reward to the company of such a governance structure will be more stable financing at lower cost than would otherwise be available.

II) Managing patient capital and illiquidity risk

Shareholders in unlisted companies are typically restricted in terms of their ability to sell their ownership stakes. By definition, the shares of unlisted enterprises are not quoted or traded on public equity markets. Furthermore, company law restricts the sale or marketing of shares in non-listed companies to the general public (or even to any persons without a prior connection with the company or its existing shareholders).

Restrictions on the transfer of shares may also be introduced by the shareholders themselves (e.g. through the company's articles of association or shareholder agreements). As a result, the shareholders of unlisted companies may find themselves in the uneasy position of being "captive" owners of a company.

This lack of liquidity presents shareholders with a significant investment risk. Investors are forced to commit themselves to the company for the medium to longer term. In contrast to the owners of listed companies, they do not have the option of easily selling their shares when they are in disagreement with the company's strategy or if they believe the company's activities become too risky.

An effective corporate governance framework provides a way of mitigating this risk. It provides shareholders in unlisted companies with some reassurance that, although there is no easy exit from their ownership stake, their interests will continue to be respected and safeguarded by the board and company management. Moreover the governance framework may also induce reflection on a possible exit strategy for those shareholders that feel the necessity to exit the company's share capital partly or completely.

As a result, shareholders are more likely to invest in the company in the first place. Furthermore, they will be more comfortable in their role as patient capital partners, and be a source of support for the company over the longer term.

III) Building corporate reputation in line with societal expectations

Unlisted companies have to operate within a social context in which there exists growing public scrutiny of corporate behaviour. The governance of companies is an issue of increasing interest for the media and civil society. Furthermore, the public demand for improved corporate accountability and transparency has grown in the wake of the recent financial crisis.

Existing corporate governance codes for listed companies are also raising the profile of corporate governance. In particular, global corporate governance principles (e.g. those of the OECD) are shaping societal norms of "appropriate" corporate structures, procedures and behaviour.

In assessing whether companies are governing themselves appropriately, public opinion is unlikely to pay much regard to nuances such as whether an enterprise is listed or unlisted. Indeed, unlisted companies may even be viewed with greater suspicion by external observers due to their lower levels of transparency in comparison with publicly-listed entities.

Good governance can play a crucial role in gaining the respect of key external stakeholders – such as actual and potential financiers, employees, customers, and local communities. It effectively provides a "licence to operate", since it offers external stakeholders some assurance that the company is being run in an appropriate and responsible manner, with due regard for the interests of "non-insiders".

When company behaviour does not fulfil the expectations of society, the company may suffer significant consequences. Even if the firm is not breaking any formal laws, it may be operationally affected by the negative perception of employees and consumers. The implementation of a robust governance framework is the main means by which such significant reputational risks can be mitigated.

3) Constructing a governance framework – the key actors

An effective governance framework establishes stable and accepted relationships between shareholders, the board, management, and other stakeholders. In effect, it defines an agreed distribution of power between the main players involved with the firm. This is an essential prerequisite for the effective operation of an enterprise. We consider each of the main actors in turn.

I) Shareholders

There is widespread recognition – both in company law and amongst the business community - that a key objective of a private sector company is to further the interests of its shareholders. According to company law in the Baltic countries, the board should act in an honest and reasonable way for the benefit of the company and its members (shareholders) as a whole.

However, in practice, shareholders do not tend to have direct power over the operation of a company. The power of shareholders primarily arises from their ability to appoint, dismiss, and influence the decision-making of the board of directors.

Such powers are defined both by company law (which establishes a baseline of shareholder rights) and the specific contents of a company's constitutional documents, i.e. the articles of association.

In addition, shareholders may enter into agreements amongst themselves. These shareholder agreements may further define the rights and responsibilities of shareholders, e.g. relating to the transferability of shares or the rights of different categories of shareholding.

Beyond compliance with the law, a governance framework must decide how the shareholder's interaction with the company should be organised. For example:

- How can shareholders call a shareholder meeting?

- How can shareholders table resolutions at a shareholder meeting in order to influence or veto the decision-making of the board, nominate or dismiss individual directors?

- What information should be provided by the company to shareholders?

In addition, a governance framework may wish to highlight the responsibilities as well as the rights of shareholders. A proactive and constructive relationship between shareholders and the board will increase mutual understanding and commitment, both at times of crisis and during normal business conditions.

One of the difficulties faced by shareholders in asserting their interests is that they are not necessarily a homogeneous group. There may be a variety of competing or conflicting objectives. This may be a particular problem in family companies, where some family members are actively involved in the management of the company and others are not.

In such cases, it is important for a governance framework to define accepted relationships between shareholders. This will include procedures by which conflicts can be anticipated and resolved in an effective manner. Also effective procedures for family governance can enhance the long-term success of family-owned companies.

II) Directors

One of the main shareholder rights is to nominate the directors and define the powers the board of directors is entrusted with. As such, the shareholders ultimately define the overall contours of the governance framework.

According to company law in the Baltic countries, the board of directors is envisaged as the primary decision-making body of the company (apart of shareholders' meeting). It is collectively responsible for all aspects of the company's activities. Notwithstanding the possibility for shareholders to limit the power of the board, its broad responsibilities are:

- to establish and maintain the company's vision, mission, and values.
- to establish its structure, strategy, and risk profile.
- to delegate authority to management, and to monitor and evaluate its implementation of policies, strategies, and operational plans.
- to account to – and be responsible to – shareholders and other stakeholders.

A governance framework will formally establish the board's specific responsibilities. It will define the board's structure, size, and composition, and the process by which directors are appointed to the board.

The organisation and logistics of board meetings are important aspects of the governance framework. Key issues include the role of the chairman, the frequency of board meetings, the management of the board's agenda, the nature of the information provided to directors, the taking of minutes, the nature and style of boardroom discussions and decision-making, and the role of the company secretary.

The governance framework should also determine if the board should delegate specific board responsibilities to committees, e.g. an audit, nomination or remuneration committee.

People as well as organisational structures are essential to effective governance. Consequently, a governance framework will establish ways of identifying potential management and board-level talent, and ensure that directors understand their legal and moral responsibilities as company directors (including their personal liabilities).

DIRECTORS' LEGAL DUTIES[8]

Company law defines a number of general legal duties for directors of companies. These include the following[9]:

THE DUTY TO ACT FOR THE BENEFIT OF THE COMPANY AND ITS SHAREHOLDERS[10]

Directors must act for the benefit of the company and its shareholders and seek to implement the purposes of the company.

THE DUTY TO ACT IN GOOD FAITH AND WITH REASONABLE CARE [11]

Directors must act honestly and exercise reasonable care when performing the duties. The meaning of 'reasonable care' is judged according to what may reasonably be expected of a cautious person and whether the director acts bona fide towards the company.

THE DUTY TO ACT WITHIN POWERS[12]

Directors must act in accordance with applicable laws, the company's constitutional documents (i.e. the articles of association) and decisions of shareholders' meetings, and only exercise powers for the purposes for which they are conferred.

THE DUTY TO ADHERE TO CONFIDENTIALITY[13]

Directors must adhere to confidentiality while performing their duties and ensure that the company's confidential information is not disclosed to third parties.

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8 *'Director'* means any member of management or supervisory board of a company.

9 Although general duties of directors are similar in all the three Baltic countries, the specific content of the duties and their judicial interpretation may differ in each of the concerned jurisdictions.

10 Sometimes it is also referred to as the *'duty of loyalty'*. In the Estonian and Lithuanian legislation it is explicitly stipulated that directors shall be loyal to the company, while in the Latvian legal system the duty of loyalty is derived from the duty of care. Furthermore, in Lithuania the Company Law (Article 19 Paragraph 8) states that the bodies of the company shall act for the benefit of the company and its shareholders.

11 Generally, the duty of care presupposes that directors act on a well-informed basis having evaluated potential risks and outcomes and in the best interests of the company and its shareholders. More specifically, in Estonia directors shall perform their obligations with the diligence normally expected from a member of a directing body (Paragraph 35 of the General Part of the Civil Code Act). In Latvia directors are expected to act as an honest and careful manager (Section 169(1) of the Commercial Law). In Lithuania directors shall act in good faith and reasonably with respect to the legal person and its members (Article 2.87 of the Civil Code).

12 See Paragraph 35 of the General Part of the Estonian Civil Code Act, Section 169 of the Latvian Commercial Law and Article 19(8) of the Lithuanian Company Law.

13 See Paragraphs 186 and 313 of the Estonian Commercial Code; Article 2.87 of the Lithuanian Civil Code. In Latvia the duty of confidentiality is not set forth separately rather than follows from the duties of loyalty and care.

THE DUTY TO AVOID CONFLICTS OF INTEREST[14]

Directors must avoid situations in which they could have direct or indirect interests that conflict with the interests of the company (e.g. holding an ownership interest in a competitor). Directors must inform the board and/or its shareholders about a possible conflict of interest within a reasonable period of time.

THE DUTY NOT TO USE THE COMPANY'S PROPERTY FOR PERSONAL OR THIRD PARTY INTEREST

Directors may not use the property of the company in order to benefit themselves or third parties. The same rule applies in respect of the proprietary information of the company, i.e. directors are prohibited from disclosing such information or otherwise using it for personal benefit.

14 See Paragraphs 181(3), 185, 307(3) and 312 of the Estonian Commercial Code; Sections 171, 221(5) and 309(3) of the Latvian Commercial Law; Articles 2.87(3) and 2.87(6) of the Lithuanian Civil Code and Article 35(5) of the Company Law.

III) Management

Management has the greatest capacity to determine the success or failure of the enterprise. Although managers are not the firm's key decision-makers, they are responsible for running the firm on a day-to-day basis. In that role, they need to be granted executive power to exercise discretion over the operation of the firm

A key aspect of the governance framework is to establish an appropriate level of executive power to delegate to management. If too little power is granted – and a manager's freedom of action is excessively constrained – the company is likely to become inflexible. Management may be unable to implement the board's strategy. However, with too much power, the risk exists that management will lose touch with the interests of the board and shareholders, and pursue its own agenda.

The governance framework must also work to align the incentives of management with shareholders and other stakeholders. The remuneration policy and contractual conditions with respect to the most senior managers, e.g. the managing director or CEO, are particularly important in that respect. Top management succession is also an important issue that should be addressed by the governance framework.

IV) Stakeholders

The role and impact of other company stakeholders – such as employees, financiers, suppliers, local communities, and government – varies considerably across companies, sectors and countries. In the Baltics, companies have fewer formal obligations to include stakeholders in their governance framework than in some other European countries[15].

However, regardless of legal obligations, the governance framework should always take into account the interests of stakeholders. The risks to the firm – reputational and otherwise – of insufficiently incorporating the stakeholder perspective into governance arrangements could be considerable. Consequently, it is important to consider ways of establishing dialogue and constructive engagement with relevant stakeholders.

4) Foundations of good governance – key concepts

The design of a credible framework of governance involves the linkage of the key corporate governance actors with a number of widely-accepted principles of good governance.

I) Delegation of authority

In any company, the origin of authority is ownership. However, the company may soon reach a point in its development where the main shareholder is no longer able to simultaneously fulfil the roles of shareholder, lead director, and manager. At that point, it becomes necessary to reflect on the most effective way to delegate authority from the owner to the board and the management.

The articles of association (or equivalent constitutional document) and shareholder resolutions exist to formalise the rights of shareholders.

The owner and/or the board should develop a systematic approach towards the delegation of authority and formalise this in writing. A schedule of matters reserved for the board and for executive management should be established, which sets out the parameters of the delegated authority (with attention for any financial thresholds regarding decision-making powers).

Delegated authorities should be reviewed periodically to ensure that they remain appropriate given the structure, size, scope, and complexity of the firm.

15 For example, in Lithuania directors of the company are expected to take into account stakeholder interests but not necessarily follow them. In this regard, representatives of employees must be informed, and consulted with, in respect of the implications for employees of the business and financial activities of the company. However, there is no statutory requirement to include representatives of employees on company boards (in contrast to the requirements of codetermination legislation in Germany, Austria and Scandinavia).

II) Checks and balances

A basic principle of good governance is that no one individual should have unfettered power over decision-making. There should exist "checks and balances" that subject the actions of individuals to scrutiny, while the most important decisions should be taken on a collective basis.

Fulfilling this principle is often a challenge for owner-managed companies, which are normally established on the basis of the autocratic control of a single individual (or small group of individuals). However, while such a governance approach may be viable in the early stages of a company's development, it is not a sustainable model for the longer term. Building the right checks and balances is therefore a delicate exercise for any developing company and will probably necessitate a "phased" or stepwise approach to align governance needs with the founder/owner's willingness to accept external control.

A side from the practical difficulties involved in a single person making all the decisions, a lack of appropriate checks and balances exposes the enterprise to human weakness. Even the most capable of individuals can sometimes make mistakes or lose their ability to analyse issues in an objective manner.

To minimise these risks, it is important to establish governance procedures that subject all decision-making to some kind of third-party scrutiny. There should also be clear lines of accountability with the firm – each corporate actor (whether an employee, manager, or director) should justify their actions to someone else. Corporate transparency is also an effective means of encouraging appropriate behaviour (see below).

Specific examples of checks and balances within the corporate structure include splitting the role of leading executive management (chief executive) from that of chairman of the board, the utilisation of a "four eyes" principle when signing contracts or making important commitments on behalf of the firm, the obligation to have an external auditor, and the involvement of independent directors on the board.

III) Professional decision-making

The focus of collective decision-making in most companies is the board of directors. However, directing an organisation through a board is more difficult than is commonly supposed. Simply placing competent people of goodwill around a boardroom table will not necessarily result in an effectively functioning board. Building an effective board takes time and patience on the part of board members, and benefits from a professional approach to boardroom procedure.

The chairman has a particular responsibility in welding a group of capable individuals into an effective board team. The chairman has to find a way to reach a consensus between diverging views on the company and its future. An atmosphere of open discussion should be encouraged. Perspectives and viewpoints should be properly documented in the minutes, allowing dissenting voices to be recorded. There should also be a clear formulation of decisions, so that the decision-making process is followed by decisive action.

It is also important to ensure that due care is taken over the choice of board members, and that board members have the necessary skills and competencies to fulfil their responsibilities. Directors will need to undertake specialised professional training if they are to effectively make the transition from operational manager (with a focus on one aspect of a firm's activities) to company director (where they must exercise oversight over the firm as a whole).

IV) Accountability

Within a company, there should be a hierarchy of accountability. Each level in the hierarchy is granted defined responsibilities and powers. However, these powers must be associated with meaningful accountability regarding performance and the exercise of powers.

The accountability hierarchy begins at the bottom of the pyramid, with each superior level monitoring and supervising the level below it. Employees are accountable to managers, who themselves report into the board of directors. Finally, the board of directors is accountable to shareholders and other external stakeholders (including government agencies and regulators).

For accountability to exert an effect over behaviour, it is important that each employee, manager, and board member understands expectations about the nature and scope of his or her responsibilities. As the company expands in size and complexity, this will require formalisation in the form of explicit business conduct rules (including ethical principles). At the board level, directors should clarify their responsibilities by defining corporate governance principles for the firm, which should be regularly reviewed and updated.

Once responsibilities have been defined, the efficient functioning of the system depends on proper oversight. However, this will only be possible if there exists relevant information with which to evaluate behaviour and performance.

For this reason, an appropriate framework of reporting and control is an important aspect of good governance. Senior managers, directors, shareholders, and other stakeholders need reliable and understandable information with which to evaluate performance. In most cases, such reporting will be undertaken by both internal departments (e.g. management accounting reporting and internal audit) and external intermediaries (e.g. the external auditors).

V) Transparency

Transparency regarding the firm's activities can be highly effective in encouraging high standards of behaviour. Directors, managers, and employees are likely to give greater thought to their conduct if they perceive that they are being observed. This perspective is summarised by the maxim that "sunlight is the best of all disinfectants".

A certain level of transparency in the firm's activities may be mandated by law and regulation (e.g. publication and audit of financial statements). The nature of such statutory transparency is likely to be relatively tightly defined. However, unlisted companies may choose to voluntarily disclose more information than required by law as a means of gaining the confidence and commitment of external stakeholders.

Given the fact that unlisted companies are often labelled as "closed" companies, the case for greater external transparency will need to be made to a possibly sceptical company owner/founder. Rather than making sudden changes, an appropriate strategy may involve increasing company transparency via a stepwise approach towards greater openness.

A key stage in opening up the company to external scrutiny is taken by the appointment of independent (non-executive) directors. This signals a firm's willingness to become more open and accountable in respect of its decision-making and performance assessment. The replacing of the owner-manager or founding entrepreneur by external managers can also be perceived as an important step in this direction.

At some stage, the unlisted company must make choices about the extent of its disclosure to external stakeholders. This is important if the company is seeking external capital or contemplating a future listing. But it may also be crucial for building reputational capital.

Greater transparency is beneficial in establishing the legitimacy of the company as a responsible enterprise in society. Increasingly, civil society views organisations that lack transparency with suspicion. The baseline assumption in the mind of the public is that opaque organisations have something to hide. This is a societal attitude that unlisted companies cannot afford to ignore, even if their regulatory obligations vis-à-vis transparency are less substantial than those of listed companies.

VI) Conflicts of interest

An important principle of company law is that directors have a duty to promote the success of the company as a whole. They are specifically prohibited from directing the activities of the company in favour of themselves or particular shareholders and/or stakeholders.

Even in owner-managed firms, the authority of an individual to manage the firm derives from his or her status as a director. The company should not be regarded as an extension of the personal property of the owner. Although shareholders have legally-defined economic entitlements (e.g. to dividends) and powers vis-à-vis the board (e.g. to appoint and remove directors), it is directors – not shareholders – that are charged with directing the affairs of the company. And this must be undertaken in the interests of the company as a whole.

This principle may be difficult for owner-managers or large shareholders of unlisted enterprises to accept or understand. They may view the firm's interests as synonymous with their own. This may lead to a self-interested bias in their decision-making. At worst, it could lead them to seek ways of expropriating the assets of the firm at the expense of minority shareholders or stakeholders.

Some examples of where conflict of interest situations may arise include the following:

- The firm undertakes business transactions with enterprises controlled or managed by its shareholders, leading to a potential conflict of interest between the firm and its shareholders.
- A manager or director has a personal interest in the adoption of a particular corporate strategy or policy (e.g. his or her own remuneration or the sale of company property to related family shareholders), which leads him or her to be less than objective in decision-making.
- Directors or shareholders encourage the firm to undertake activities that benefit specific shareholders (e.g. relating to dividend policy, or requiring a subsidiary company to provide special guarantees or loans to a mother or another group company) or stakeholders with which they have a strong personal association (the promotion of a family employee or decisions on succession planning).

Conflicts of interest have the potential to undermine the governance of the company. Good governance demands that the company is being steered by the board in an objective manner, and not as a means of promoting specific personal interests or enriching a specific constituency.

Consequently, a robust governance framework needs to define credible mechanisms by which potential conflict of interest issues can be managed or resolved. Directors should always declare potential conflicts of interest to the rest of the board, abstain from influencing the decision and be prepared to leave the board entirely in cases where such conflicts are structural and could eventually become detrimental to the success of the company.

VII) Aligning incentives

The incentives of directors and employees are primarily (although not entirely) shaped by the firm's remuneration policy. Remuneration is an issue that frequently attracts the attention of the media. Indeed, an impression may be gained from the public discourse that corporate governance is almost entirely about remuneration, which is of course a gross distortion.

Unlisted companies benefit from the fact that they are not subject to the same degree of public scrutiny and mandatory transparency regarding remuneration as publicly listed companies. However, unlisted companies have an equal need to ensure that remuneration policy is incentivising behaviour from directors, managers and employees in a way that is consistent with the long-term interests of the enterprise.

Furthermore, a credible and transparent remuneration policy can help win the commitment and loyalty of company stakeholders (e.g. employees, suppliers, providers of finance, the media, and the local community) to the company's objectives.

Some important issues of remuneration policy include the following:

- What are the relevant benchmarks and performance criteria in the remuneration process?
- Who makes the decisions about remuneration?
- How much information regarding remuneration issues should be disclosed?

5) The challenge of implementation

The implementation of sound corporate governance principles is not necessarily easy. It may involve a significant change in the way that companies operate and a shift in the distribution of power in relation to corporate decision-making.

For example, the necessary steps may involve the inclusion of external parties in important decisions, establishing meaningful chains of accountability, and the communication and reporting of activities to stakeholders. Such steps may be viewed with suspicion by the original owner-manager or founding-entrepreneur.

Furthermore, improved governance is likely to be associated with the increased formalisation of company processes and procedures. Many small and medium-sized companies may see this as imposing an unnecessary bureaucratic burden on their enterprises.

Consequently, there exist important prerequisites for the implementation of a corporate governance framework:

- The firm's key decision-makers – normally the shareholders or the owner-manager – must themselves be convinced of the need to implement a robust governance framework. The commitment of these parties is essential in order to make governance work.
- Although the governance framework should pay due regard to best practice principles, it should also be implemented in a manner that is both proportionate and realistic. Corporate governance is not an end in itself, but a means of adding value and providing continuity. Given the diversity amongst unlisted firms, corporate governance principles should be applied in a pragmatic and flexible manner, with regard to the individual circumstances of each company.

The implementation of a corporate governance framework should also take account of the firm's objectives concerning its own development. A corporation will generally develop a new governance structure and approach in anticipation of its next major strategic move or phase in development or financing structure (e.g. before succession takes place in a family firm, before attracting external capital, etc.). Such a change in governance will indicate its readiness to take the next step in its evolution.

Events in the company's life cycle that may trigger a change in governance approach include the following:

- Changes in the relationship between shareholders, the board and management. This may be triggered by the desire of the founder entrepreneur or family owners to withdraw from the day-to-day management of the company, and hand over executive responsibilities to professional managers. A special trigger of governance change may be the decision to nominate the first independent non-executive director on the board.

- Expansion of the shareholder base by attracting additional internal (family, group) shareholders. This may trigger important challenges for the sole owner (e.g. the founder).

- Change in the capital and shareholding structure, due to a desire to attract external financing. This will involve dilution in the ownership concentration of existing owners, and the entry into the company ownership of external shareholders.

- Increasing complexity in the firm's business portfolio, its business environment, and its risk profile.

The BICG principles of best practice presented in the next section of this briefing are voluntary recommendations, leaving the companies the freedom to decide on the way in which they should be implemented in practice. Companies have the latitude to decide on the pace and depth of their governance implementation process.

The BICG principles do not stipulate any form of obligatory disclosure or an application of the comply-or-explain principle[16]. According to the OECD[17], an excessively formal approach in the case of unlisted companies would have adverse implications for costs and flexibility. Consequently the principles should not be viewed as a corporate governance code, but rather as a set of proposals aimed at increasing the professionalism and effectiveness of unlisted companies.

Once a choice is made regarding an appropriate governance framework, it should be implemented with a high level of discipline and consistency. The credibility of the firm in the eyes of its various shareholders and stakeholders (e.g. employees, creditors, suppliers, customers) will be affected by the manner of its implementation. Furthermore, good governance requires more than the implementation of formal rules and processes. Equally important is the right governance attitude, which applies the spirit of key governance principles throughout the organisation.

If a new corporate governance framework is perceived to be just window dressing, it will deliver few of the potential benefits of good corporate governance.

16 The comply-or-explain principle underpins the application of the Corporate Governance Codes for the companies listed on NASDAQ OMX Stock Exchanges in Tallinn, Riga and Vilnius.. According to this principle, a company must either comply with the principles of the code or explain its reason for not complying in its annual report.

17 OECD (2006), page 14.

Part II: Principles of corporate governance for unlisted companies in the Baltics

The BICG and ecoDa governance principles – a phased approach

Reflecting the diversity of unlisted companies, fourteen governance principles are presented on the basis of a dynamic stepwise process. This approach takes into account the specific nature of a company in terms of size, complexity, and maturity. Two categories of corporate governance principles are proposed.

Phase 1 principles (principles 1-9) apply to all kinds of unlisted companies, regardless of size or level of complexity. Such principles are viewed as broadly universal in their application, and do not necessarily require the creation of bureaucratic or costly governance procedures. They represent a core framework of basic governance principles that can be implemented in some form by all unlisted companies.

It should be recognised, however, that even the application of the first phase principles will probably necessitate a stepwise approach. As has already been highlighted, the introduction of basic governance principles, such as external transparency, checks and balances, and external control, is a delicate exercise in an owner-managed firm, or in any company with a sole owner or decision-maker. Owners need to be convinced that the application of such principles will bring a substantial return and foster the long-term success of their firm.

Phase 2 principles (principles 10-14) are more sophisticated corporate governance measures that are relevant to larger or more complex unlisted companies, government-owned enterprises or enterprises with significant external financing. They should also be considered by unlisted companies that are seeking to prepare themselves for a future public listing.

The most important of the phase 2 principles is the decision to invite independent directors onto the board. This is a landmark event in the evolution of an unlisted company. It normally signals an irreversible step towards good governance and is likely to exert an immediate effect over the culture of boardroom behaviour. The implementation of phase 2 principles is likely to increase the formality of governance arrangements. However, this is invariably a necessary step in larger or more complex enterprises in order to provide the necessary reassurance to owners or external creditors regarding the longer-term sustainability of the enterprise.

In short, the BICG and ecoDa principles offer a phased approach to corporate governance, both in terms of the way in which individual principles are implemented and in the transition from the phase 1 to the phase 2 principles. This provides a governance roadmap for family owners or founder-entrepreneurs as they plan the development of their companies over the corporate life cycle.

After a statement of each of the governance principles, a number of key points are listed. The application of these points is likely to underpin the implementation of each governance principle. This is followed by a discussion of the practical issues that are likely to be of interest to unlisted companies of differing sizes and levels of complexity in addressing each of the BICG principles.

It must be stressed that the objective of the BICG principles is to provide insight for unlisted companies in the design of a governance framework. They are not intended to be a straitjacket. Unlisted companies should exercise common sense in their implementation, and ensure that their response is both proportionate and tailored to the specific needs of their organisation.

Phase 1 principles – applicable to all unlisted companies

Principle 1:
Shareholders should establish an appropriate constitutional and governance framework for the company.

Key points

- Shareholders should establish a basic framework of corporate governance through the company's constitutional documents (i.e. the articles of association).
- There should be a formal schedule which states which matters are specifically reserved for the shareholders' decision and which are to be delegated to the board (see principle 2).
- However, shareholders should minimise the extent to which the articles constrain the ability of the board to shape the detailed governance framework.

Practical considerations for unlisted companies

The company's constitutional documents define the "rules of the game" with respect to many aspects of a company's corporate and internal governance. They can be used to establish company rules relating to matters such as the issuance of shares, the different voting and dividend rights attached to different classes of shares, restrictions on the transfer of shares, the powers, role and conduct of board and shareholder meetings, and the appointment and remuneration of directors (see also principle 2).

The articles essentially represent a contract between the company and its owners. They bind the way in which directors can subsequently exercise power over the company. A director that ignores the constraints defined by the articles is at risk of acting *ultra vires* ("beyond powers") and may be subject to legal sanction.

The detailed content of company articles is often given little attention by owner-managers in the early stages of a company. In many instances, company founders rely on so-called "model articles"[18]

However, prior to further development of corporate governance, it is important for shareholders to consider if the existing constitutional framework is in the long-term interests of the company and adapted to its specific needs.

In particular, shareholders should avoid embedding too much detail on governance procedures in the articles of association. The articles are an inflexible means of establishing a governance framework. According to company law in the Baltic countries, they can only be changed via a special resolution of shareholders. Consequently, they impose severe constraints on the ability of the board of directors to tailor the governance framework to the changing needs of the company.

Shareholders should recognise that the board is the primary decision-making body of the company. This role should not be undermined by an excessively prescriptive approach to governance in the articles of association.

However, in some unlisted companies, there may be governance issues which are of significant personal concern to the founding-entrepreneur or existing shareholders, e.g. concerning the transferability of shares or succession issue procedures. A constitutional framework which safeguards the interests of the owners in these areas is likely to be an important prerequisite for further development of the governance framework.

Investors in unlisted companies take – in many respects – a bigger investment risk than investors in listed enterprises. The illiquidity of their shareholdings may require them to commit to the company for a relatively long period of time. A constitutional framework that protects their long-term interests is likely to be an important determinant of their willingness to invest in the company.

Shareholders may also wish to ensure that their specific interests are guaranteed in relation to the interests of other shareholders. Company owners may have diverging aspirations for the company. In a relatively widely-held family company, for example, it is almost inevitable that such differing objectives will come into conflict at some point.

The constitutional framework offers a way of defining relationships and conflict-resolution procedures between shareholders. This will help to ensure stability over the longer term.

In contrast to the articles of association, shareholder agreements are contractual agreements between shareholders of the company. In some circumstances, shareholder agreements may be seen as a more flexible and effective means of safeguarding shareholder rights than the company's articles of association.

However, unlike the articles – which are publicly accessible documents – shareholder agreements lack transparency (they are confidential agreements between private parties), and there may exist uncertainty over their enforceability. Consequently, over time, shareholders should seek to move away from shareholder agreements as a means of safeguarding their essential interests.

When undertaking changes to articles of association or shareholder agreements, shareholders should seek the guidance of qualified legal counsel in order to ensure that any proposed changes are in accordance with relevant company law.

18 For example, in Lithuania so-called "model articles" are published by the Ministry of Economy, but they are not obligatory.

Principle 2:

Every company should strive to establish an effective board, which is collectively responsible for the long-term success of the company, including the definition of the corporate strategy. However, an interim step on the road to an effective (and independent) board may be the creation of an advisory board.

Key points

- The board's role is to provide leadership of the company.
- As an intermediate step on the road to an effective main board, small unlisted companies may consider the establishment of an additional advisory board, without formal decision-making responsibilities.
- All directors must take decisions objectively in the interest of the company. As the company develops, inviting an independent director onto the board can help in focusing the board on the corporate interest.
- The board should elect a chairman. The chairman is responsible for leadership of the board, ensuring its effectiveness on all aspects of its role and setting its agenda.
- The board should appoint a Chief Executive (or managing director) to lead the management team, and exercise executive authority over the operation of the company.
- The board should set the company's strategic objectives, and ensure that the necessary financial and human resources are in place for the company to meet its objectives.
- The board is responsible for monitoring and evaluating management performance.
- The board should set the company's values and standards and ensure that its obligations to its shareholders and other stakeholders are understood and met. The board should be involved in the strategic development process and – as a minimum – approve the strategy, and ensure that it lies within the framework of shareholders' expectations.

- It is the responsibility of the board to ensure that the company complies with its articles of association as well as relevant legal, regulatory, and governance requirements.

- There should be a formal schedule of matters which states which matters are specifically reserved for the board's decision and which are to be delegated to management.

- Where directors have concerns which cannot be resolved about the running of the company or a proposed action, they should ensure that their concerns are recorded in the board minutes.

Practical considerations for unlisted companies

In many smaller unlisted companies, the distinction between the members of the governance tripod of board, management, and shareholders is often unclear. An owner-manager may fulfil all or several of these roles.

Nonetheless, it is important to recognise the unique role that the board plays in the leadership of the company. It has overall responsibility for the company's activities.

At an early stage of a company's development, it may be appropriate to operate many aspects of the board's activities in a relatively informal and non-bureaucratic manner.

An interim step on the road to a more independent board is the creation of an (additional) advisory board. In contrast to the main board, such a body lies outside the formal governance structure of the firm. As a result, the decision-making powers of the owner-manager or controlling family on the main board remain undiluted. However, the advisory group helps improve the board's capabilities in terms of expertise and business contacts (see principle 3). Over time, members of the advisory group can be invited to join the main board as directors.

As the company grows in size and complexity, so should the board. Conversely, the advisory board should diminish in importance. An advisory group cannot exercise proper monitoring and oversight over the company. Unlike a formal board, it has no right to obtain information and cannot exercise significant influence over company strategy. In addition, it cannot be held legally liable for the firm's activities (except in those cases in which it can be proved to be acting as a "shadow director" of the company).

Consequently, the formalisation of board and governance processes should increase in tandem with the size and complexity of the company, and the extent of its reliance on external sources of finance.

As the company develops further, external and independent directors can play a crucial role on the route to a professional governance framework. Introducing independent directors is a key step in the development of unlisted company governance (see also principle 11). The decision to invite external independent directors onto the board forms part of a professionalisation process. Its potential effect on boardroom behaviour and culture should not be underestimated.

At a relatively early stage, written statements should be developed to help the board clarify its objectives and strategy, and ensure that all concerned parties understand what is expected of them.

A statement of the company's strategy as defined by the board – supported by a business plan prepared by the management and approved by the board – is a basic necessity. Over time, the board should also seek to develop a company manual that documents all company policies and procedures, e.g. in relation to health and safety policy, legal and regulatory obligations, staff and procurement policies, etc.

Board statements should define the board's responsibilities, reserved matters and delegated authorities. However, given its positioning as an intermediate corporate organ between shareholders and management, the duties of the board are often defined in a "residual" manner, i.e. board duties exclude all rights and duties reserved to the shareholders (meeting) or delegated to management.

Within the framework set by the shareholders, the board defines its own responsibilities, and on the duties and responsibilities it wants to delegate to management. Although the detailed definition of those specific duties will differ substantially between individual companies, some general frameworks can be described.

A schedule of matters reserved for shareholders (possibly at a shareholders' meeting), would typically include the following:

- Approval of the annual accounts
- Deciding on the dividend
- Approval of changes to the articles of association/ and/or changes to capital structure
- Appointment, remuneration, and dismissal of directors.

A schedule of matters potentially reserved for the board would typically include the following:

- Definition of corporate goals, strategy, and structure
- Responding to shareholders and third parties
- Supervising and controlling company progress
- Supervising the Chief Executive or managing director
- Approval of corporate plans
- Approval of operating and capital budgets
- Approval of major corporate actions (e.g. acquisitions, disposals, commencing or terminating of business activities)
- Approval of financial statements
- Approval of borrowings or creditor guarantees (possibly above a certain amount)
- Policy on external communications, e.g. with regulators, shareholders, or the media
- Definition of authorities delegated to management
- Nomination and dismissal of the managing director/CEO, and on his/her remuneration (possibly also of other top management, in consultation with the CEO).

A schedule of powers delegated to management is likely to cover the following areas:

- Preparing strategic proposals, corporate plans, and budgets
- Executing the strategy agreed upon by the board of directors
- Executing actions in relation to board decisions on investments, mergers, and acquisitions, etc.
- Opening bank accounts and authorising financial payments

- Signing of contracts
- Signing of regulatory documents
- Powers of attorney
- External communication
- Staff recruitment and remuneration
- Establishing a system of internal control and risk management
- Health and safety operations.

It is best practice to summarise such a schedule of delegation in a delegation policy document, specifying the limits for each of the delegated matters.

The balance between matters reserved for the board and matters delegated to management should be kept under regular review, particularly in a rapidly growing company. Owner-managers need to develop an effective approach to delegation, and learn to spread decision-making powers to other directors and managers.

Boards should maintain a compliance schedule, which shows when various financial, legal, and regulatory requirements must be completed, and who is responsible for dealing with each item. Such a schedule is likely to include:

- obligations relating to the preparation and filing of financial statements
- tax compliance
- banking facilities and covenants
- health and safety compliance
- insurance

Small unlisted companies may wish to appoint an external party, e.g. a lawyer, accountant, or provider of company secretarial services, to ensure that the board fulfils its statutory obligations. In addition, it may be prudent to grant power of attorney to an external adviser to act when directors are unavailable or in an emergency.

As the company expands, it may be appropriate to appoint an in-house company secretary to fulfil these requirements.

A key responsibility of the board is to promote high standards of professional and ethical conduct amongst employees. As the number of employees expands, the standards expected should be summarised in a code of business conduct. This should be discussed with employees during induction and training periods. It also acts as a benchmark for evaluation during disciplinary proceedings.

The internal code could state the company's expectations with respect to:

- compliance with laws and regulations
- standards of customer service
- conflicts of interest
- gifts or preferential treatment in respect of suppliers, customers, etc
- the need for integrity and ethical business practice
- company obligations to the general wellbeing of the community
- support for employee personal development.

Principle 3:
The size and composition of the board should reflect the scale and complexity of the company's activities.

Key points

- The board should not be so large as to be unwieldy. The balance of skills and experience should be appropriate for the requirements of the business. Changes to the board's composition should be manageable without undue disruption.

- There should be an explicit procedure for the appointment of new directors to the board. Appointments to the board should be made after careful examination against objective criteria.

- The board should satisfy itself that plans are in place for orderly succession for appointments to the board and to senior management. The aim is to maintain an appropriate balance of skills and experience within the company and on the board.

- The period of appointment of directors should be carefully considered. The board should balance the flexibility of open-ended appointments against the need to ensure planned and progressive refreshing of the board.

Practical considerations for unlisted companies

During the early years of the company's existence, owner-managers may be uncomfortable about inviting outsiders onto the board. They may not yet be ready to share sensitive company information and decision-making powers with external persons. Hence the board often consists of owner-managers' colleagues, family members, or close friends.

As the company grows, more focus will be placed on the board, which is the key decision-making body of the company. As the success of the company will depend more and more on the board, it is in the owner-manager's interest to get the best possible people onto the board.

The board structure of companies differs across Europe. Although shareholders always have the right to nominate (part of) the highest decision-making body, that body has different names according to the type of board structure in place.

In principle, a two-tier board structure is envisaged by company law of all the three Baltic countries. I.e. supervision and management functions are fulfilled separately by the supervisory board and the management board, as opposed to the board of directors in a unitary board structure (e.g. in the UK). However, companies are permitted to adopt different board structures. For example, some companies may have only a management board consisting of solely executive directors (who combine their board role with a senior managerial position) or a board comprising both executive and non-executive (some of which may be independent) directors. Other companies may have two boards: the supervisory board composed of non-executive directors and the executive or management board (which is responsible for execution and operational matters).[19] It is also worth mentioning that in Lithuania the CEO must not necessarily be a member of the management board.

The composition of the board is vitally important and should be addressed seriously. The company's future may require a variety of expertise on the board including marketing, logistics, finance, production, legal, human resources, international trade, mergers & acquisitions, etc.

Regardless of nationally-defined structures, the ability of any form of committee to make decisions and exercise proper scrutiny becomes increasingly difficult at sizes in excess of 10-12 members. A smaller board size will improve the quality of communication and is likely to result in more focused discussions. They will also make board meetings easier to organise.

During the early years of the company's existence, owner-managers may be uncomfortable about inviting outsiders onto the board. They may not yet be ready to share sensitive company information and decision-making powers with external persons.

However, this may result in the board lacking expertise in a number of key strategic areas, e.g. relating to strategy analysis, marketing, finance, human resources management, or international trade. As a result, it may make sense to create an additional advisory board, which can fill the expertise gaps in these areas (see principle 2).

19 In Estonia and Latvia public companies must have the supervisory board and the management board.

However, an advisory board should only be regarded as an interim step. Over time, non-executives should be added to the main board. Providers of external finance are also likely to insist on non-executive directors joining the board (see principle 12).

In an owner-managed company, it is likely that a single person will initially fulfil the roles of both chairman and chief executive (or managing director). A separate independent chairman may not be commercially justifiable. However, the person holding both roles should remember that the responsibilities of chairman and CEO are distinct, and should be viewed separately.

Succession planning is a particularly important issue in owner-managed companies. The owner needs to consider if the ultimate objective is to pass on the business to younger family members or to seek an exit from the business through a public listing or trade sale. Answers to these questions will influence decisions regarding the appropriate composition of the board.

Boards should comprise people with different perspectives, backgrounds, and experience. Board renewal is important to ensure a flow of new ideas.

Service on too many boards can interfere with the performance of board members. Companies should consider whether multiple board memberships by the same person are compatible with effective board performance.

It is important that members of the board enjoy legitimacy and confidence in the eyes of shareholders. Transparency towards shareholders is therefore important in any company. Extra services to the company, undertaken on behalf of the board – and the associated remuneration – should be disclosed to shareholders.

Principle 4:

The board should meet sufficiently regularly to discharge its duties, and be supplied in a timely manner with appropriate information.

Key points

- Consideration should be given to the appropriate organisation of board meetings.

- The chairman is responsible for ensuring that the directors receive accurate, timely, and clear information.

- Management has an obligation to provide such information. However, directors should seek clarification or amplification from management where necessary. The board should establish explicit procedures which allow directors to approach management for further information.

- The board should ensure that directors – especially non-executive directors – have access to independent professional advice at the company's expense where they judge it necessary to discharge their responsibilities as directors.

Practical considerations for unlisted companies

Given the specific leadership role of the board, it is important to distinguish board meetings from management meetings, even in owner-managed enterprises.

Too many board meetings may result in the board becoming too operational. On the other hand, too few meetings may pose problems for the fulfilment of the board's duties. Therefore sufficient attention should be given to the appropriate number of board meetings.

Smaller companies will typically have four to eight board meetings per annum, possibly including a full-day strategic board meeting. However, the exact number of meetings required by the board to fulfil it responsibilities will depend on the specific needs of the company.

Board meeting dates should be "fixed in stone" as far as possible. Frequent date changes can lead to poor attendance by non-executive directors.

The chairman should ensure that board meetings are run efficiently and should consider developing board guidelines with respect to meeting procedures and agenda-setting. A typical structure for board meetings is as follows:

- An agenda should be prepared by the chairman.

- The agenda and supporting papers (if any) should be circulated in advance of the meeting, allowing directors sufficient time to prepare.

- Written minutes of board meetings should be taken. All decisions should be recorded (including dissenting opinions), along with assigned tasks and timescales. The minutes should also give an overview of the main topics discussed at the meeting.

- Board meetings should monitor progress against approved plans and budgets, and ensure full coverage of matters reserved for the board.

As well as promoting better decision-making, a track record of properly documented board meetings is an important indicator of professionalism. Furthermore it is an important legal safeguard for directors, and may assist smaller companies in obtaining external financing at a later stage.

Board members require relevant information on a timely basis in order to support their decision-making. However, a principal concern of many boards is not to increase the quantity of the information that they receive. Rather, it is to increase the quality. Information needs to be summarised and formatted in a manner that makes it accessible and useful for directors.

It is the board's responsibility to decide what information it wants. However, an informational tool that is widely used by boards is the "balanced scorecard". This goes beyond financial measures of performance, and also tracks success according to a range of quantitative and qualitative criteria. It may include measures of customer satisfaction, indicators of training and professional development amongst employees, and qualitative indicators of progress on business processes, e.g. major projects or compliance with health and safety standards.

Directors may wish to supplement the information they receive from management with information from other channels, such as departmental visits, with or without the chief executive present, and reports prepared by external think-tanks, academics, or regulatory bodies. However, the search for additional information should be undertaken after consultation with the chairman of the board and the CEO.

Principle 5:

Levels of remuneration should be sufficient to attract, retain, and motivate executives and non-executives of the quality required to run the company successfully.

Key points

- A clear distinction must be made between the remuneration of executives and non-executives. The former are full-time employees of the company, and are responsible for its operational activities. In contrast, non-executives are "office holders" rather than company employees, and dedicate their time to the company on a part-time basis. Remuneration structure should reflect these differing roles.

- Members of the board are ultimately accountable to shareholders for their remuneration. However, in practice, many boards will themselves define and propose to the shareholders' meeting any change in their annual remuneration.

- Levels of remuneration for non-executive directors should reflect the time commitment and responsibilities of the role.

- Caution should be exercised when linking non-executive remuneration to company performance.

- The board should develop a formal executive remuneration policy and a transparent procedure for implementing the policy, e.g. in terms of fixing the remuneration packages of individual executives and non-executives.

- No one should be involved in deciding on his or her own remuneration.

- Boards should compare the remuneration of their executives and non-executives with that of other relevant companies. But they should use such comparisons with caution, in view of the risk of an upward ratchet of remuneration levels with no corresponding improvement in performance.

- Boards should be sensitive to pay and employment conditions elsewhere in the company, especially when determining annual salary increases.

- A significant proportion of executive remuneration should be structured so as to link rewards to corporate and individual performance. They should be designed to align their interests with those of shareholders and other key stakeholders, and give these executives incentives to perform at the highest levels.

- The board should consider the financial implications of early termination of executives' terms of office. In addition, careful thought should be given to notice or contract periods. The aim should be to avoid rewarding poor performance.

Practical considerations for unlisted companies

Although board remuneration is ultimately a matter for shareholders, initial responsibility over this area is often delegated to the board (through the firm's articles of association, although board decisions may still require approval from shareholders).

In contrast to executives, non-executive directors are normally remunerated on a fixed-fee basis. This is to ensure that non-executives retain an objective and independent perspective on the activities of the company. For this reason, share options would not normally form part of a non-executive's remuneration framework.

Shareholders and boards may consider the rewarding of non-executives through stock. However, although stock ownership may increase the alignment of directors' interests with those of shareholders, the board should be aware that equity holdings may affect external perceptions of independence (see principle 11). The compatibility of stock-based remuneration with non-executive duties is ultimately a matter for shareholders.

Although care should be exercised in linking non-executive remuneration to performance, there should exist a relationship between compensation and the attention and effort required of the individual director. Directors should receive higher remuneration for a greater time commitment, e.g. arising from participation on board committees.

The board should ensure that executive remuneration (particularly that of the chief executive) is reasonable and aligned with the performance of the company. The performance of the company should be measured not only in terms of the achievement of short-term financial targets, but also on the basis of a qualitative assessment of the extent to which a company is fulfilling its longer-term objectives.

In an increasing number of companies, boards develop and disclose a remuneration policy statement covering board members and key executives. Such policy statements specify the relationship between remuneration and performance, and include criteria that emphasise the longer-run interests of the organisation over short-term considerations.

For unlisted companies this external transparency may initially be a bridge too far, but open governance information can be a step on the road to a higher degree of professionalism and transparency (certainly for Phase II companies).

Good practice in executive remuneration is likely to consider the following elements in its design:

- A balance between fixed and variable pay, and the linkage of variable pay to pre-determined performance criteria

- Deferment of some proportion of variable pay

- In cases where shares are granted, a minimum vesting period. A requirement to retain some proportion of those shares until the conclusion of employment

- The reclaim of variable pay paid on the basis of data which subsequently proves to be manifestly misstated ("clawback")

- A limit on severance pay, and non-payment of severance pay in case of poor performance.

It is important that both executive and non-executive compensation is as transparent and straightforward as possible. It is helpful to canvas what other similar companies pay to ensure that compensation is not out of line, and many boards turn to external experts for this information.

However, boards should exercise caution in their use of remuneration consultants or head-hunters in defining pay levels. In particular, they should pay attention to consultants' potential conflicts of interest (e.g. in advising both executives and non-executives from the same company). The board needs to develop its own pay philosophy, and should avoid just going along with the crowd.

Principle 6:

The board is responsible for risk oversight and should maintain a sound system of internal control to safeguard shareholders' investment and the company's assets.

Key points

- The board should attempt to identify the main risks facing the company. It should satisfy itself that all material risks are being appropriately managed.

- The board should establish formal and transparent arrangements for applying financial reporting and internal control principles, and for maintaining an appropriate relationship with the company's auditors.

- The board should periodically assess the need to establish a formal internal control and risk management function. Moreover, a periodic check on the effectiveness of the company's approach towards internal control is necessary. Such review should cover all material controls, including financial, operational and compliance controls, and risk-management systems.

Practical considerations for unlisted companies

Risk is an inherent part of being in business. The elimination of risk is neither a realistic nor a desirable aim. However, risk needs to be managed. The company should not expose itself to risks that it does not understand or which are not relevant to the success of its business.

In an owner-managed business, risk issues are likely to be addressed by the owner in a relatively informal manner. However, it is helpful to document risks where possible, e.g. using a straightforward SWOT (strengths, weaknesses, opportunities, threats) framework or risk mapping, as this will help to focus decision-making and demonstrate that directors have approached risk management with the necessary care and diligence. Not only financial risks have to be taken into account but also operational and strategic risks.

It is useful for companies to develop a basic risk register, which is reviewed by the board on a regular basis. This will contain the following categories of information:

- A description of the main risks facing the company
- The impact should this event actually occur
- The probability of its occurrence
- A summary of the planned response should the event occur
- A summary of risk mitigation (the actions that can be taken in advance to reduce the probability and/or impact of the event).

Directors of smaller unlisted companies should approach professional advisers to gain input on how to establish appropriate internal control processes. As the company grows in size and complexity, it will be necessary to move towards a more professional system of internal control. Strong financial controls will become a significant requirement if the company wishes to obtain external sources of finance.

Notwithstanding the development of more sophisticated internal controls, the CEO should always view him/herself as the *de facto* chief risk officer, and seek to encourage an appropriate sense of risk consciousness at all levels of the company.

In larger companies, risk management may become a particular focus of a boardroom audit committee or an internal audit department. However, even when many aspects of risk management are delegated to specific individuals or corporate bodies, it is important that the board as a whole retains ownership of risk supervision.

All members of the board should have a feeling for the main business risks. Furthermore, the board should establish ways of monitoring the development of these risks and seek reassurance that such risks are being managed in an appropriate manner by the management team.

A company manual should be available to all employees, and should outline policies and procedures relating to the specific risks to which the company is exposed. For example, policies should be developed with regard to:

- anti-fraud
- anti money-laundering
- cash management
- monitoring of banking covenants
- business continuity
- data security and reliability
- records management
- regulatory compliance
- health and safety compliance.

Procedures which are likely to support an effective internal control environment are likely to include:

- authorisation limits
- segregation of duties
- accounting reconciliations and monitoring of cash flow
- suitable qualifications and training
- budgetary controls
- controls over funds, expenditure, and access to bank accounts
- security of premises and control over assets.

In fulfilling its control and oversight responsibilities, it is important for the board to encourage the reporting of unethical/unlawful behaviour by employees. The existence of a company code of ethics should aid this process and should be underpinned by legal protection for the individuals concerned.

Principle 7:

There should be a dialogue between the board and the shareholders based on the mutual understanding of objectives. The board as a whole has responsibility for ensuring that a satisfactory dialogue with shareholders takes place. The board should not forget that all shareholders have to be treated equally.

Key points

- The board should keep in touch with shareholder opinion in whatever ways are most practical and efficient.
- The chairman has particular responsibility for the effectiveness of communication between shareholders and the board, and should discuss corporate governance and strategy with shareholders.
- The chairman is the primary means of ensuring that the views of shareholders are communicated to the board as a whole. However, other directors should also be offered the opportunity of attending meetings with shareholders.
- A key role of the chairman is to set the agenda of the Annual (and Extra-ordinary) General Meetings.
- The relationship with the shareholders should be viewed as a continuous process and not limited to an annual formal meeting.

Practical considerations for unlisted companies

Shareholders of unlisted companies may particularly value a close dialogue with boards due to the illiquidity of their shareholdings. In contrast to listed companies, they are less able to express their views on a company's strategy and risk profile through the buying and selling of their shares.

Engagement and communication with boards allows them to ensure that the company is moving in a direction that is consistent with their interests (particularly with regard to the risk/reward profile of the company's strategy). It is, therefore, a key way in which they may seek to manage the higher liquidity risk of their ownership stakes.

According to company law in the Baltic countries, unlisted companies are required to hold an Annual General Meeting (AGM). An AGM is a useful way to structure a dialogue with shareholders that are not involved in the management of the company.

It is also likely to be a useful means of developing board-shareholder dialogue in cases where the shareholders are a relatively large and heterogeneous group.

An AGM provides a well established mechanism in which to review the activities and performance of the past year, and to discuss the future prospects of the company.

However, in certain cases, shareholders may require a much more frequent and ongoing dialogue with the board. Alternatively, the main shareholders may still be actively involved in the company as managers and/or directors.

Ultimately, board-shareholder dialogue and engagement should be structured to suit the particular circumstances of each company.

Boards should give particular thought to how they communicate the company's strategy and risk profile to shareholders. This should be done in a way that is both understandable and meaningful.

Furthermore, it should be undertaken in a spirit that recognises that a key duty of the board is to ensure that the activities of the company remain fully aligned with the interests of shareholders.

Principle 8:

All directors should receive induction on joining the board and should regularly update and refresh their skills and knowledge.

Key points

- The rigour and formality of the induction should reflect the size and complexity of the enterprise.
- The chairman should ensure that the directors continually update their skills, and obtain the knowledge and familiarity with the company required to fulfil their role on the board.
- The chairman should encourage board members to engage in professional training that specifically enhances their functioning as company directors.

Practical considerations for unlisted companies

Director orientation is an essential means of providing non-executive directors with the informational building blocks they need to effectively engage in strategic reflection and oversight. It is also important for executive directors, who may come from a functional background and may not yet be used to exercising oversight across the company as a whole.

New directors may wish to request the opportunity to meet fellow board members in advance of the first board meeting. A request for orientation by a new director sends a strong signal that the director is serious about his or her role on the board.

In the Baltics, it is possible for directors to develop and update their director-specific skills by qualifying as a professional board member. Such a professional qualification provides a framework within which to undertake continuing professional development. It also establishes an ethical and disciplinary framework within which to hold directors to account. BICG provides such board-level education programmes.

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Principle 9:

Family-controlled companies should establish family governance mechanisms that promote coordination and mutual understanding amongst family members, as well as organise the relationships between family governance and corporate governance.

Key points

- The choice of family governance processes will depend on the size of the business, the number of family members, and the degree of involvement of family members in the business.
- A family constitution or protocol should outline the vision and objectives of the family for the business. It should define the roles of family governance bodies, and their relationship with the board of directors. It should also state key family policies, e.g. relating to family members' employment, transfer of shares, and CEO succession.
- Family governance bodies – such as a family assembly and a family council – provide family members with a forum in which to discuss the affairs of the family and the family business, and assist the development of a coordinated family approach.
- A clear distinction in governance status must be made between family institutions and the formal governance structures of the company. The role of the board, shareholder meetings, etc, must be fully understood by family members.

Practical considerations for unlisted companies

Most family companies are unlisted enterprises. However, research shows that family businesses have a short lifespan beyond the generation of the founding-entrepreneur. Very few survive into the third generation of ownership. Family businesses can improve their odds of survival by setting the right governance structures in place and by starting the educational process of the subsequent generations as soon as possible.

Many founding-entrepreneurs or chairs of family companies find it difficult to differentiate their decision-making between family matters (continuity, valuation, liquidity, transmission, dividends, etc) and corporate matters (operation-related decisions).

When the company is still under the control of the founding entrepreneur, few family governance issues may be apparent. However, over time and several generations, the family is likely to increase in size and complexity. Family members may develop different preferences for the business. For example, a decision to reinvest profits in the company instead of distributing them as dividends may be supported by an owner-manager but opposed by a retired family member who relies on dividends as a main source of income.

A further problem for larger families is that members who work in the business have greater access to information than those whom are not directly involved in the business.

In such circumstances, it becomes desirable to establish family governance structures that establish a level playing field for company information, promote discipline among family members, prevent potential conflicts, and ensure the continuity of the business.

Once such structures are created, it must be clear that family governance should be distinct from business governance, with each institution having its specific composition, duties, and matters to discuss and decide upon.

A family constitution outlines how this family governance structure should work. It clarifies the family's approach with respect to the following:

- The family's values, mission statement, and vision
- The role of family institutions, such as the family assembly and the family council
- The role of the board of directors, and its relationship to the family institutions
- Policies regarding important family issues, such as employment policies with respect to family members, restrictions on transfers of shares, and succession policy with respect to the CEO
- The nomination of the family members of the board.

A family assembly may meet once or twice per year, and brings together all members of the family. It allows family members to stay informed about the business and furnishes them with the opportunity to voice their opinions. It helps avoid potential conflicts that might arise due to an unequal access to information and other resources.

A family council is a small group of family members or family representatives that acts as the primary decision-making body of the family vis-à-vis the company. It is also the main communication link between the family and the company and has a crucial role in conveying the expectations of the family owners to the board. It is normally elected by the family assembly.

Family institutions can play a useful role in coordinating and unifying the interests of extended families. However, the most important step for ensuring the long-term survival of a family company is the establishment of a strong board with independent non-executive board members[20] (see principle 11).

Phase 2 principles – applicable to:

- **Larger and/or more complex unlisted companies**
- **Unlisted companies with significant external financing**
- **Government-owned unlisted companies**
- **Unlisted companies aspiring to a public listing**

20 John Ward, *Creating Effective Boards for Private Enterprises* (1991).

Principle 10:

There should be a clear division of responsibilities at the head of the company between the running of the board and the running of the company's business. No one individual should have unfettered powers of decision.

Key points

- In larger companies, the roles of chairman and chief executive (or managing director) should not be exercised by the same individual. The division of responsibilities between the chairman and chief executive should be clearly established, set out in writing, and agreed by the board.

- Over time, companies should strive to nominate an independent chairman. However, as an interim measure, appointment of the exiting CEO (e.g. the founding entrepreneur or *pater familias*) as chairman may be the most viable option.

Practical considerations for unlisted companies

Smaller unlisted companies may not have the resources to appoint a separate board chairman. However, the roles of chairman and chief executive are fundamentally different. Consequently, once a company expands beyond a certain size and level of complexity, the board should give thought to splitting the two roles.

The chairman is pivotal to the operation of the board. He or she must coordinate the contributions of the non-executive directors to ensure that the executive team is subject to a sufficient degree of oversight. There is a danger that the fulfilment of this role will be compromised if the chief executive is also fulfilling the role of chairman.

It is sensible to explicitly clarify the chairman's role vis-à-vis the role of the chief executive through a formal statement of responsibilities. This document should define what matters are reserved for the board and what matters are reserved for management. As a general rule, the chief executive leads the management team and runs the company while the chairman leads the board.

The statement of responsibilities should be reviewed periodically. Developing such a statement is a useful way of ensuring that everyone understands their role and is not stepping on anyone's toes, and that there are no surprises.

Once appointed, the chairman is required to walk a narrow line. He or she must be sufficiently informed, engaged, and able to intervene when required, but must avoid becoming too involved with the day-to-day business of the company. Board dysfunction is likely to result when the distinct roles of the chief executive and chairman are not properly understood or respected.

Principle 11:

All boards should contain directors with a sufficient mix of competencies and experiences. No single person (or small group of individuals) should dominate the board's decision-making.

Key points

- Although there may be difference depending on the circumstances of individual companies, the board of larger companies should include a sufficient number of non-executive and independent directors.

- The largest unlisted enterprises – or unlisted enterprises working towards a public listing on a regulated market – should aim to add non-executive directors and preferably independent directors to boards until they represent a significant proportion of board seats (although the exact proportion will be a matter for the judgement of individual boards).

- Care should be taken to ensure that non-executive or independent appointees have enough time available to devote to the job. This is particularly important in the case of chairmanships. The letter of appointment should set out the expected time commitment. Non-executive or independent directors should undertake that they will have sufficient time to meet what is expected of them. Their other significant commitments should be disclosed to the board before appointment and the board should be informed of subsequent changes.

- The chairman should facilitate the effective contribution of non-executive and independent directors and ensure constructive relations between all directors.

- Non-executive and independent directors should constructively challenge and help develop proposals on strategy.

- Non-executive directors and independent directors should scrutinise the performance of management in meeting agreed goals and objectives and monitor the reporting of performance.

- Non-executive directors and independent directors should satisfy themselves on the integrity of financial information and make sure that financial controls and systems of risk management are robust and defensible (although their approval remains a collective responsibility).

- Non-executive directors and independent directors should assume primary responsibility for determining appropriate levels of remuneration of management, including executive directors. They should also play a leading role in appointing, and where necessary removing, executives, and in succession planning.

- The chairman may decide to hold meetings with the non-executive directors without the executive directors present.

- Non-executive or independent directors may be appointed for a specified term (e.g. an initial mandate for three years, possibly renewable a couple of times). Decisions to extend terms of service should balance the need for company-specific experience (which may take time to acquire) and the benefits of a progressive refreshing of the board. It should also be recognised that serving for many years on a board may affect external perceptions of a non-executive director's independence.

- On resignation, a non-executive director should provide a written statement to the chairman, for circulation to the board, if they have significant concerns about the running of the company.

Practical considerations for unlisted companies

Once a company reaches a certain size and level of complexity, an independent board, i.e. a board containing independent non-executive directors and not entirely composed of company or family insiders, becomes essential to the long-term success and survival of the company.

Even for Phase I companies, the introduction of external directors onto the board is a key event in the corporate governance development of an unlisted company. However, once such companies become larger or have more complex shareholding structures, they should progressively rely more on non-executive and independent directors (eventually up to a majority of board seats for those interested in listing on the stock exchange). More diverse board composition generates a significant impetus towards better governance and is likely to have significant impact on the culture of boardroom decision-making.

The key benefits of including independent non-executive directors on the board include the following:

- Bringing an outside perspective on strategy and control
- Adding new skills and knowledge that may not be available within the firm
- Bringing an independent and objective view from that of the owner
- Making hiring and promotion decisions independent of family ties
- Bringing an independent view whenever there may be conflicts of interest within the board
- Acting as a balancing element between the different shareholders (e.g. members of the family) and, in some cases, serving as objective judges of disagreements amongst family members or managers
- Benefiting from their business connections and other contacts.

Director independence is not a concept that can be precisely defined. However, factors which may be of relevance in establishing the perceived independence of a non-executive director include the following:

- Has not in recent years been an employee of the company
- Has not a material business relationship with the company
- Does not receive (additional) remuneration from the company during the period of appointment as a director (apart from the director's fee)
- Does not have close family ties with any of the company's advisers, directors, or senior employees
- Does not hold cross-directorships or have significant links with other directors through involvement in other companies or bodies
- Does not represent a significant shareholder
- Has not served on the board for an extended period.

However, these are only guidelines. Ultimately, it is a matter for the board to determine if the director is independent in character and judgement, and whether there are relationships or circumstances which are likely to affect, or could appear to affect, the director's judgement.

For example, extended service on a board is sometimes thought to negatively impact director independence. However, this will depend on the individual director. A director who serves on a board for an extended period should still be considered independent if that director possesses strength of character and is willing and able to challenge management, while providing value added on the base of in-depth knowledge of the company and its strategic challenges.

Non-executive board members will not typically have the same access to information as executive directors or the owner-manager. The contributions of non-executive board members can be enhanced by providing them with access to managers within the company (although such contacts should be coordinated with management, and non-executives should take care not to undermine the authority of the management).

In certain circumstances, non-executives may also be assisted by offering access to independent external advice at the expense of the company, although this generally is undertaken with the knowledge of the board as a whole, in order to avoid creating a confrontational atmosphere between executive and non-executive board members.

In smaller unlisted companies it may be tempting to seek the assistance of independent non-executive directors in undertaking management or staff functions. However, independent directors should not generally be involved in operational functions or take on a considerable consultancy role.

Independent directors need to retain a degree of distance from operational activities. Their specific role is to ensure that the management team is taking the correct steps and is using available resources in the most efficient manner. If independent directors do assume an additional consultancy role, it should receive explicit approval from the board.

The board should consider appointing a company secretary who reports to the chair (via a joint report to the chief executive) to ensure that directors receive information in a timely way without excessive reliance on management (even if this is not a formal legal requirement). A board with its own secretariat will generally be in a stronger position to demand information than a board whose secretary reports solely to the chief executive.

However, such designated administrative support for non-executive directors is only likely to be commercially viable in relatively large unlisted companies.

Principle 12:

The board should establish appropriate board committees in order to allow a more effective discharge of its duties.

Key points

- A company's committee structure should be proportionate to the needs of the company. However, most large unlisted enterprises are likely to require a nomination committee, remuneration committee, and audit committee. Other committees may be established if required in particular circumstances.

- The board should define in writing the terms of reference of the various committees, explaining their role and the advisory authority delegated to them by the board. These terms of reference should be reviewed by the board on a periodic basis.

- Committees should be provided with sufficient resources to undertake their duties.

- Independent non-executive directors should play a significant role in boardroom committees.

Practical considerations for unlisted companies

A nomination committee can be established to lead the process for board appointments and make recommendations to the board. The role of the nomination committee is to evaluate the balance of skills, knowledge, and experience on the board, as well as amongst top management. In the light of this evaluation, it will prepare a description of the role and capabilities required for a particular board appointment, and propose a management succession plan.

A remuneration committee is granted delegated responsibility for proposing the remuneration of all executives, including pension rights. The committee should also define and monitor the level and structure of remuneration for senior management.

It may make sense to (initially) combine the responsibilities of the nomination and the remuneration committee into a single committee.

The audit committee plays a particularly important role in the monitoring and oversight of larger companies. The main responsibilities of the audit committee include the following:

- To monitor the integrity of the financial statements of the company
- To review the company's internal controls and risk management systems
- To monitor and review the effectiveness of the company's internal audit function
- To make recommendations to the board in relation to the appointment or removal of the external auditor
- To approve the remuneration and terms of engagement of the external auditor
- To review and monitor the external auditor's independence and effectiveness
- To develop and implement policy on the engagement of the external auditor to supply non-audit services
- To review the risk situation, and to monitor risk-management processes.

Given the relatively technical nature of the audit committee's activities, the board should satisfy itself that at least one member of the audit committee has recent and relevant financial experience. In practice, this is likely to mean that this individual has an accountancy qualification, and has gained relevant financial experience while working as an auditor or financial manager. The majority of the members of the audit committee should be non-executive, and preferably independent directors.

Where there is no internal audit function, the audit committee should consider whether there is a need for an internal audit function and make recommendations to the board.

The audit committee should also review arrangements by which staff of the company may, in confidence, raise concerns about possible improprieties in matters of financial reporting or other matters ("whistleblowing").

No one other than the committee chairman and members should be entitled to be present at a meeting of boardroom committees. However, others may attend at the invitation of the committees.

Principle 13:

The board should undertake a periodic appraisal of its own performance and that of each individual director.

Key points

- The rigour and formality of the appraisal techniques utilised by the board should reflect the size and complexity of the enterprise. Once again, a stepwise or phased approach is the best route ahead for smaller companies.

- The chairman should use the appraisal process to obtain feedback on the effectiveness of his or her management of the board.

- Group appraisal should examine how the board operates as a collective decision-making body.

- Individual appraisal should aim to show whether each director continues to contribute effectively and to demonstrate commitment to the role (including commitment of time).

- The chairman should act on the results of the appraisal by recognising the strengths and addressing the weaknesses of the board and, where appropriate, proposing new members be appointed to the board or seeking the resignation of directors.

- Special attention should also be paid to the assessment of the collaboration with the (executive) management.

Practical considerations for unlisted companies

The chairman is responsible for working with the board to ensure that it is a high-performing team composed of the right people. He or she occupies a crucial position with respect to board functioning. Board dysfunction will result if the chairman is not sufficiently focused on board dynamics and behaviour.

Chairs cannot improve their chairmanship without honest and constructive feedback. They must be open to input from the rest of the board in order to improve their performance.

There are many ways to undertake board appraisal, including self-evaluations, third-party facilitations, and peer reviews prior to re-election to the board. Board appraisal conducted by independent external facilitator is likely to be more objective in its rigour than self-assessment, and should be favoured as the firm grows in size and complexity.

Board appraisals should be designed to elicit an honest discussion about what is going right and what is going wrong on the board. Some of the key questions that an appraisal should address include the following:

- Is the distribution of power in the boardroom appropriate?
- Is there sufficient challenge of executive management in board meetings?
- Does the board have the right balance between expertise and independence?
- Does the board correctly perform its duties? Are directors setting direction (guidance and advice on strategy) and monitoring the company (control and risk management) and its management?
- Do board members devote sufficient time and effort to the company and their boardroom role?
- Do board members have adequate access to information and advice?
- Does the board engage sufficiently with shareholders and key stakeholders?
- Are there personal factors that might inhibit individual board members from fulfilling their duties in an independent and objective manner?

Evaluating individual directors is a very sensitive issue, given the fact that the board is a collegial body, composed of peers. Therefore caution will be necessary in order to avoid possible conflicts and frustrations. Here again, the chairman or an external facilitator can be instrumental in bridging the gap between individual and confidential evaluations and a more global discussion of the board's effectiveness, remuneration, and composition.

Feedback to the board as a whole can be provided by the chair or external facilitator. The chairman should also be able to provide individual directors with feedback as needed so as to encourage self-improvement. The chairman should coach individual directors by providing continuous feedback and assigning them to work with others to improve board dynamics and teamwork.

The board should also be responsible for evaluating the chief executive. The chairman should drive the process. One approach for the chairman is to gather a self-assessment from the CEO and compare it with the confidential information gathered from the other directors and use this information in appraisal discussions with the chief executive. It is important to integrate in such an appraisal exercise the mutual evaluation of the collaboration between the board and the management.

A strong-minded independent chairman is in a good position to assess the performance of individual directors and that of the executive director or top manager. However, a chairman that is too close to management will lack objectivity and credibility in fulfilling the assessment of management. This also holds for evaluating the performance of the role of chairman versus that of CEO. This highlights the need for the chairman to retain an independent profile relative to the chief executive or otherwise appoint a lead director and/or involve an external facilitator for such assessment.

Although a formal or externally administered boardroom appraisal process may only make sense for larger unlisted companies, all companies should recognise the importance of periodically evaluating the effectiveness of the board as a decision-making unit.

Principle 14:

The board should present a balanced and understandable assessment of the company's position and prospects for external stakeholders, and establish a suitable programme of stakeholder engagement.

Key points

- The board should publish an annual report that is tailored to the needs of its shareholders and its other stakeholders.

Practical considerations for unlisted companies

A strong disclosure regime that promotes transparency will be a pivotal feature of a company's relationship with stakeholders. Disclosure improves public understanding of the structure and activities of the company, its policies with respect to environmental and ethical standards, and its relationship with the communities in which it operates.

The annual report is an important means of communicating with stakeholders (as well as shareholders). Apart from the traditional financial reporting, annual reports can include more information on the following corporate issues:

- A statement of the company's vision and values.
- A narrative outline of the company's business strategy and the likely risks associated with that strategy.
- A review of the company's activities and performance, and a forward-looking assessment of its business environment.
- A statement of its corporate governance principles and the extent to which it has complied with a specific corporate governance code, with additional governance information, such as:
  - a statement of how the board operates, including a high-level statement of which types of decisions are to be taken by the board and which are to be delegated to management;
  - the names of all the directors, including the chairman, the chief executive, and the chairmen and members of the nomination, audit and remuneration committees (if relevant);
  - the names of the non-executive directors whom the board determines to be independent, with reasons for that assessment where necessary;
  - details of how any evaluation of the board, its committees, and its directors has been conducted.
- A summary of activities and projects of special relevance to stakeholders.

The content of the annual report will become more important as the company develops.

Social responsibility projects can act as a major point of engagement with stakeholders. They should be integrated into the company's activities and included in management's list of strategic goals.

Direct communication between directors and employees can be an effective way of driving a message home across an organisation. They help to ensure that everyone is “singing from the same hymn book”. In cases where such communication takes place on the initiative of individual directors, such contacts should be in line with a general “internal governance” policy developed by the board. If such policy is not yet developed, it is good practice to inform the chairman and CEO before taking any such steps.

However, in all such direct meetings with employees, the directors should emphasise that the chief executive is ultimately in charge of the management of the company. Directors should ensure that they communicate confidence in the management team, and avoid discussing detailed management issues with employees to minimise the risk of mixed messages.

The board can facilitate communications by providing a contact person with whom stakeholders may discuss any issues. During times of change, it may be useful for the board to communicate regularly with stakeholders to explain what is happening at the company. For example, stakeholders of a company contemplating a major expansion or retrenchment – or merger with another company – may wish to meet with the board to discuss the proposed strategy for the new organisation.

Stakeholders – including individual employees and their representative bodies – should be able to freely communicate their concerns about illegal or unethical practices to the board. Their rights should not be compromised for doing this. Unethical and illegal practices by corporate officers may not only violate the rights of stakeholders but also be to the detriment of the company in terms of reputation effects with an increasing risk of future financial liabilities. It is therefore to the advantage of the company to establish procedures and safe harbours for complaints by stakeholders.

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