CORPORATE GOVERNANCE

The Combined Code on Corporate Governance contains 14 Principles of Good Governance applicable to listed companies. The paragraphs below together with the report on Directors' remuneration set out on pages 81 to 89 describe how these Principles are applied within GKN.

The Board and its Committees

The GKN Board currently comprises six executive and six non-executive Directors and reflects a blend of different ages, experience and backgrounds. The roles of Chairman (which is a non-executive position) and Chief Executive have been split since 1997 and there is a clear division of responsibility between the two. In the opinion of the Board, all the non-executive Directors are independent of management and free from any business or other relationship which could materially interfere with the exercise of their independent judgement.

Upon appointment, Directors receive induction training and, thereafter, individual training is available as required. Directors also have direct access to the advice and services of the Company Secretary who is tasked with ensuring that Board procedures are followed. In addition, Directors may, in furtherance of their duties, take independent professional advice, if necessary, at the Company's expense.

The Board normally meets ten times a year, two of which are on the sites of subsidiary or joint venture companies. Comprehensive briefing papers on items for consideration are circulated to each Director one week prior to a Board Meeting. During 2002, the Directors' overall rate of attendance at Board Meetings was 95.5%.

During 2002, the Board carried out an evaluation of Board and Board Committee effectiveness covering, inter alia, composition, arrangements for and content of meetings, Committee terms of reference, Director training and visits to operating sites, access to information and administrative procedures. The results of the evaluation were considered by the Board and certain recommendations were implemented.

Under the Company's articles of association, each of the Directors is required to retire by rotation at least once every three years. Details of the Directors retiring and seeking re-election at an Annual General Meeting are given to shareholders in the Notice of Meeting.

Specific responsibilities have been delegated to the following Board Committees:

Executive Committee

Comprises the executive Directors under the chairmanship of the Chief Executive. The Committee, which normally meets monthly, oversees the activities of the Group, decides how the various risks facing the Group are to be managed and approves major human resource policy issues including management development and training.

Chairman's Committee

Comprises the non-executive Directors and the Chief Executive under the chairmanship of the Chairman. It normally meets before Board Meetings and is a forum for the Chairman and the Chief Executive to brief the non-executive Directors.

Audit Committee

Comprises the non-executive Directors (except Dr Klaus Murmann) under the chairmanship of Roy Brown. It meets three times a year and more frequently if required. The Committee examines the process of financial reporting within the Group and reviews changes in Group accounting policies. It also reviews annually the Group's system of internal control and the processes for monitoring and evaluating the risks facing the Group. The Committee reviews the scope and results of the audit with the external auditors and the terms of reference and results of the work of the internal audit department. It is also responsible for ensuring that an appropriate relationship between GKN and the external auditors is maintained, including reviewing non-audit services and fees (see 'Independence of external auditors' on page 80).

Remuneration Committee

Comprises the non-executive Directors (except Sir David Lees) under the chairmanship of Baroness Hogg. It meets periodically as required. The Committee is responsible for approving the terms of service and setting the remuneration of the executive Directors and the Company Secretary in accordance with a remuneration policy which is approved annually by the Board.

Nominations Committee

Comprises the non-executive Directors and the Chief Executive under the chairmanship of the Chairman. It meets periodically as required. The Committee assesses and recommends to the Board candidates for appointment as executive and non-executive Directors of the Company and as Company Secretary. It makes recommendations to the Board on its composition and balance and as to the appropriate processes for the appointment of executive Directors, non-executive Directors, the Chairman of the Board and the chairmen of Board Committees. It also reviews proposals for changes in responsibilities of Directors.

Shareholder communications

Meetings between Directors, senior management and major institutional shareholders are held periodically in accordance with GKN's investor relations programme and when required in relation to particular issues. All Directors normally attend the Annual General Meeting and shareholders are invited to ask questions during the meeting and to meet with Directors after the formal proceedings have ended. Shareholders at the meeting are advised as to the level of proxy votes received and, following each vote on a show of hands, the percentage of proxy votes for and against each resolution is announced.

In its annual and interim reports, trading statements, results presentations and City announcements generally, GKN endeavours to present an accurate, objective and balanced picture in a style and format which is appropriate for the intended audience. The Company's website (www.gknplc.com) provides financial and business information about the Group including copies of annual and interim reports and presentations made to institutional investors.

Internal control

The Board attaches considerable importance to the Group's systems of internal control and risk management. It acknowledges its responsibility for them and for the regular review of their effectiveness.

The Board's policy is to have systems in place which optimise the Group's ability to manage risk in an effective and appropriate manner. The Board has delegated to the Executive Committee responsibility for identifying, evaluating and monitoring the risks facing the Group and for deciding how these are to be managed. There is a standing agenda item at every Executive Committee meeting to enable members of the Committee to advise if any material internal control issues have arisen or any significant new risks have been identified.

Continuing processes are in place for all parts of the Group to assess the major strategic, commercial and financial risks to which their operations are exposed, the social responsibilities relating to such operations and the way in which such risks and responsibilities are monitored, managed and controlled. ('Social responsibilities' concern the responsibilities of the Group to various stakeholders including its employees, the communities in which it operates, its business partners and the environment including behaving ethically and with regard to human rights. The Group's Social Responsibility Review is on pages 26 to 33.) These processes are summarised in a 'risk map' reviewed annually by the Audit Committee.

Each year all Group businesses are required formally to review their business risks and to report on whether there has been any material breakdown in their internal controls. Companies also have to confirm annually their adherence to statutory and regulatory obligations as well as with internal policies on matters such as competition law, employment law, ethics, document management, data protection and employee disclosure. Risk profiling is undertaken across all subsidiaries to identify accidental risks and highlight action required to mitigate such risks.

In implementing its policy on managing accidental risk, the Group pursues a systematic integrated loss prevention approach to safeguard people's health, the environment, an uninterrupted supply to its customers, its assets and its earnings, under the auspices of a Group Loss Prevention Council. The Council formulates and recommends Group loss prevention policies and acts as a steering group for loss prevention activities across Group operations.

The Group has one major 50:50 joint venture, AgustaWestland, which was formed in 2001 when GKN and Finmeccanica merged their respective helicopter manufacturing businesses. The AgustaWestland Audit Committee is responsible for the overview of the corporate governance systems adopted by AgustaWestland that are appropriate to the business and comply with the requirements of both shareholders.

The Group's systems are designed to manage rather than eliminate the risk of failure to achieve business objectives, recognising that any system can only provide reasonable and not absolute assurance against material misstatement or loss.

The review process

The Board reviews the effectiveness of the systems of internal control and risk management on an ongoing basis by:

› considering the strategy of the Group at both Group and divisional level and, within the framework of this, approving an annual budget and medium-term projections. Central to this exercise is a review of the risks and opportunities facing each business and the steps being taken to manage these;

› reviewing on a regular basis operational performance and updated forecasts for the current year. Comparisons are made with budget and the prior year and appropriate action plans put in place to optimise operational and financial performance;

› retaining primary responsibility for acquisition and divestment policy, and the approval of major capital expenditure and financing arrangements. Below Board level there are clearly defined management authorities for the approval of capital expenditure, major contracts, acquisitions, investments and divestments, together with an established framework for their appraisal, which includes a risk analysis and post-implementation plan and, where appropriate, a post-acquisition review;

› receiving regular reports on the Group's treasury activities, having approved the operating policies and controls for this function;

› performing an annual review of the Group's pension fund arrangements and insurance and risk management programmes;

CORPORATE GOVERNANCE CONTINUED

› receiving annual reports, following their review by the Executive Committee, on environmental, health and safety matters as they relate to the Group's operations. The Executive Committee also reviews interim reports on health and safety performance;

› reviewing annually management development and succession plans. The Executive Committee also reviews management development issues twice a year; and

› receiving regular reports from the Audit Committee on whether the systems of internal control and risk management are operating effectively.

The Audit Committee, which has independent access to the external auditors and to the internal audit function, is responsible for reviewing the ongoing control processes. It achieves this by:

› reviewing and approving the terms of reference and major findings of the internal audit department. This department has a risk-based work programme which is reviewed by the Audit Committee, and its purpose is to review and test the systems, controls, processes, procedures and practices across the Group. Its head, who reports directly to the Group Chief Executive, has access to, and regular reviews with, the Chairman of the Audit Committee. There is an established process to review the implementation of the recommendations of the department and all its reports are seen by the relevant members of the Executive Committee;

› reviewing reports from management and external and internal auditors on the effectiveness of the systems of internal control and risk management. In particular, in advance of the announcement of the Group's results for each year, it reviews a summary of the annual detailed divisional reports on their business risks and internal control processes; and

› discussing with management the resolution of control issues raised by Board members or in reports reviewed by it.

The Board has reviewed the effectiveness of the Group's systems of internal control and risk management during the period covered by this annual report. It confirms that the processes described above, which accord with the guidance on internal control published in September 1999 by the Institute of Chartered Accountants in England & Wales, have been in place throughout that period and up to the date of approval of the annual report.

Independence of external auditors
The external auditors have in place processes to ensure their independence is maintained and have written to the Audit Committee confirming that, in their opinion, they are independent.

The Audit Committee has the specific task of keeping under review the nature and extent of non-audit services provided by the auditors in order to ensure that objectivity and independence are maintained. Whilst the Audit Committee has no reason to doubt the independence or objectivity of the auditors, as a matter of policy, the auditors are excluded from invitations to undertake assignments of a consultancy nature, except where their detailed knowledge of the Group in comparison to other professional services firms is considered by the Committee to represent a tangible advantage to the Group and its shareholders.

Guidelines for the operation of the policy, including the special circumstances in which the auditors can be used for non-audit work, have been agreed by the Audit Committee and issued by the Finance Director to all Group companies.

Compliance with the Combined Code
In addition to the 14 Principles of Good Governance, the Combined Code also contains a Code of Best Practice with 45 detailed provisions. Other than with regard to two of these provisions, GKN was in compliance with the Code of Best Practice throughout 2002, the two exceptions being:

Recognised senior non-executive Director
The Board does not consider it necessary to identify a single senior non-executive Director, in addition to the Chairman, to whom shareholders' concerns can be conveyed. The chairmen of the Audit and Remuneration Committees, whose names are given on page 78, are both senior non-executive Directors and either may be approached in circumstances where investors feel it inappropriate to contact the Chairman or the Chief Executive.

Notice periods
Although not in compliance during 2002, the Board's current policy is that, unless local employment practice requires otherwise, the notice period in the service agreements of executive Directors shall be one year. The service agreements of those executive Directors who previously were entitled to two years' notice of termination have been amended to accord with this policy with effect from 1 January 2003.

The auditors' responsibilities with regard to their review of the Company's compliance with the specified provisions of the Code of Best Practice and in relation to the annual report generally are set out on page 92.