

## CORPORATE GOVERNANCE

### Compliance with the Combined Code

Throughout 2003, GKN was in compliance with the 45 provisions of the Combined Code on Corporate Governance as it applied to the Company during the year, except with regard to the requirement for a recognised Senior Independent Director. Following the appointment of Baroness Hogg as Deputy Chairman and Senior Independent Director on 1 December 2003, GKN complied fully with this version of the Code. The following paragraphs, together with the report on Directors' remuneration on pages 80 to 89, provide a description of how the 14 Principles of this Combined Code have been applied within GKN.

A new Combined Code on Corporate Governance came into effect for UK listed companies for reporting years beginning on or after 1 November 2003. Although GKN is not obliged to report on its compliance with the new Code until the publication of the 2004 annual report in the spring of 2005, the Board has reviewed its procedures with a view to complying with all of the detailed provisions of the new Code during 2004. In accordance with the Financial Reporting Council's request for companies to report early on the steps taken to implement the new Code, the following paragraphs also provide a description of how the new Combined Code is being applied.

### The Board of Directors

The Board is collectively responsible for the success of the Company. Its role is to provide entrepreneurial leadership of the Company within a framework of prudent and effective controls which enables risk to be assessed and managed; to set the Company's strategic aims, ensure that the necessary financial and human resources are in place for the Company to meet its objectives, and review management performance; to set the Company's values and standards and ensure that its obligations to its shareholders (including reporting to shareholders on the Board's stewardship) and others are understood and met. Specific responsibilities reserved to the Board include:

- › setting Group strategy and approving an annual budget and medium-term projections;
- › reviewing operational and financial performance;
- › approving major acquisitions, divestments and capital expenditure;
- › reviewing the Group's systems of financial control and risk management;

- › ensuring that appropriate management development and succession plans are in place;
- › reviewing the environmental, health and safety performance of the Group;
- › approving appointments to the Board and as Company Secretary, and approving policies relating to Directors' remuneration and the severance of Directors' contracts; and
- › ensuring that a satisfactory dialogue takes place with shareholders.

A description of the role of the Board, together with that of the Chairman, Chief Executive, Senior Independent Director and Company Secretary, is available on the GKN website at [www.gknplc.com](http://www.gknplc.com) and further details of the Board's role in relation to the Group's systems of internal control and risk management are given on pages 78 and 79. Descriptions of the specific responsibilities which have been delegated to the principal Board Committees are given on pages 76 and 77.

The Board currently comprises six executive and eight non-executive Directors as listed in the table on page 78. Biographical details of the Directors are given on pages 16 and 17. With the exception of the Chairman, who is presumed under the Combined Code not to be independent, all the non-executive Directors are regarded by the Board as independent.

The Board normally meets 10 times a year, two of such meetings being held at subsidiary or joint venture companies. Comprehensive briefing papers are provided to all Directors one week before Board meetings.

All Directors 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.

### Chairman and Chief Executive

The roles of Chairman and Chief Executive have been split since 1997. Whilst collectively they are responsible for the leadership of the Company, the Chairman's primary responsibility is for leading the Board and ensuring its effectiveness and the Chief Executive is responsible for running the Company's business.

In November 2003, GKN announced that, following selection by the Nominations Committee and Board approval, Roy Brown will replace Sir David Lees as Chairman following Sir David's retirement at the conclusion of the 2004 Annual General Meeting in May.

#### ***Induction and professional development***

On joining the Board, a Director receives a comprehensive induction pack which includes background information about GKN and its Directors, and details of Board meeting procedures, Directors' responsibilities, procedures for dealing in GKN shares and a number of other governance-related issues. This is supplemented by a briefing with the Company Secretary. The Director meets with the Chief Executive to be briefed on the general Group strategy and with the Managing Directors in relation to each individual business portfolio. Plant visits are organised as necessary for new non-executive Directors. External training, particularly on matters relating to the role of a Director and the role and responsibilities of Board Committees, is arranged as appropriate.

Ongoing training is provided as and when necessary and may be identified in annual performance reviews (see below) or on an ad hoc basis. The suitability of external courses is kept under review by the Company Secretary who is charged with facilitating the induction of new Directors both into the business and as to their roles and responsibilities as Directors, as well as with assisting in the ongoing training and development of Directors.

#### ***Performance evaluation***

Formal evaluations of the performance of the Board and of the principal Board Committees will be conducted by the Chairman in 2004. The process will build on that developed in 2002 when the effectiveness of the Board and its Committees was reviewed 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. As in 2002, the results of the evaluation will be reported to the Board and agreed recommendations for improvement will be implemented.

Evaluation of individual Directors in their role as members of the Board will also be conducted by the Chairman in 2004. The Senior Independent Director is responsible for the evaluation of the Chairman and will meet at least annually with the other non-executive Directors to appraise his performance.

#### ***Director re-election***

All Directors are subject to re-election by shareholders at the first Annual General Meeting following their appointment by the Board. Under the articles of association of the Company, 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 AGM are given to shareholders in the Notice of Meeting.

#### ***Communicating with shareholders***

Meetings between Directors, senior management and major institutional shareholders are held during the year in accordance with GKN's investor relations programme and when required in relation to particular issues. The Senior Independent Director and the other non-executive Directors are encouraged to attend presentations to analysts and shareholders, in particular the annual and interim results presentations.

In fulfilment of his obligations under the new Combined Code, the Chairman will give feedback to the Board on issues raised with him by major shareholders. This will be supplemented by twice yearly feedback to the Board on meetings between management and investors, and the non-executive Directors will receive an annual briefing from the Company's brokers on the market's perception of GKN. Existing arrangements for the whole Board to receive periodically a presentation by external consultants on investor perceptions and for external brokers' reports on GKN to be circulated to all Directors will be maintained.

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 including the percentage for and against each resolution following each vote on a show of hands, and, from the 2004 AGM, abstentions will also be advised.

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 to the intended audience. The GKN website provides information about the Group including copies of annual and interim reports and presentations made to institutional investors.

## CORPORATE GOVERNANCE CONTINUED

### Board Committees

The full terms of reference of the following Board Committees are available upon request and on the GKN website:

#### *Executive Committee*

The Executive Committee comprises the executive Directors under the chairmanship of the Chief Executive. The Committee is tasked with overseeing and directing the activities of the Group, reviewing Group strategy and deciding how the various risks facing the Group are to be managed. It also reviews acquisitions and divestments and approves major human resource policy issues including management development and training. It normally meets monthly.

#### *Chairman's Committee*

The Chairman's Committee comprises all the non-executive Directors together with the Chief Executive under the chairmanship of the Chairman. The Committee is a forum for the Chairman and Chief Executive to brief and obtain the views of the non-executive Directors on particular issues.

#### *Audit Committee*

The Audit Committee comprises all the independent non-executive Directors (other than Klaus Murmann). It is currently chaired by Roy Brown but from the conclusion of the Company's 2004 Annual General Meeting will be chaired by Sir Peter Williams.

The Committee reviewed its terms of reference in 2003 in the light of the new Combined Code and recommended to the Board certain changes, all of which have been implemented. Under its revised terms of reference, the Committee monitors the integrity of the Company's financial statements and the effectiveness of the external audit process. It is responsible for ensuring that an appropriate relationship between GKN and the external auditors is maintained, including reviewing non-audit services and fees. It also reviews annually the Group's systems of internal control and the processes for monitoring and evaluating the risks facing the Group. The Committee reviews the effectiveness of the internal audit function and is responsible for approving, upon the recommendation of the Chief Executive, the appointment and termination of the Head of that function. From 2004 the Committee will review annually its terms of reference and its effectiveness and recommend to the Board any changes required as a result of such review.

In 2003, the Audit Committee, operating under its previous terms of reference, discharged its responsibilities by:

- › reviewing the Group's draft 2002 financial statements and 2003 interim results statement prior to Board approval and reviewing the external auditors' detailed reports thereon;

- › reviewing the Group's December trading update announcement prior to release;

- › reviewing the appropriateness of the Group's accounting policies;

- › reviewing regularly the potential impact on the Group's financial statements of certain matters such as impairments of fixed asset values and proposed International Accounting Standards;

- › reviewing and approving the 2002 audit fee and reviewing non-audit fees payable to the Group's external auditors in 2002;

- › reviewing the external auditors' plan for the audit of the Group's 2003 accounts, which included key areas of extended scope work, key risks on the accounts, confirmations of auditor independence and the proposed audit fee, and approving the terms of engagement for the audit;

- › reviewing an annual report on the Group's systems of internal control and its effectiveness, reporting to the Board on the results of the review (see page 79) and receiving regular updates on key risk areas of financial control;

- › reviewing post-acquisition reports on integration and performance of significant recent acquisitions;

- › reviewing the risks associated with major business programmes; and

- › reviewing the internal audit function's terms of reference, its 2003 work programme and quarterly reports on its work during the year.

From 2004 the Audit Committee will meet at least four times a year, including meetings before the annual and interim results announcements and at the commencement of the annual external audit process. Members' attendance record at meetings of the Committee in 2003 is given on page 78.

The Committee has authority to investigate any matters within its terms of reference, to access resources, to call for information and to obtain external professional advice at the cost of the Company. Should there be any disagreement between the Committee and the Board which cannot be resolved, the Committee has the right to report the issue to shareholders within the Company's next annual report.

No person other than the members of the Committee is entitled to be present at meetings but others may be invited to attend by the Committee. Sir David Lees, who, as Chairman of the Board, ceased to be a member of the Committee in November 2003 to comply with the requirements of the new Combined Code, has continued to act as an adviser to the Committee in the absence currently of another non-executive Director having the financial background required under the new Code. A non-executive Director with the appropriate

qualifications will be appointed in 2004. The Head of the internal audit function and the external auditors usually attend meetings of the Committee. At each meeting there is an opportunity for the external auditors, and annually an opportunity for the Head of internal audit, to discuss matters with the Committee without any executive management being present. Both the Head of internal audit and the external auditors have direct access to the Chairman of the Committee outside of formal Committee meetings.

The Audit Committee has the specific task of keeping under review the nature and extent of non-audit services provided by the external auditors in order to ensure that objectivity and independence are maintained. As a matter of policy, the auditors are excluded from invitations to undertake assignments of a consultancy nature. For other non-audit work, the policy is that GKN does not use the external auditors unless there are compelling reasons to do so, i.e. they can provide a unique skill or a service not readily available from any other source. Under the policy, agreed by the Board, any proposal to use the auditors for non-audit work must be submitted to the Group Finance Director who will, depending on the nature of the service, seek the prior authorisation of the Chairman of the Audit Committee. The external auditors have in place processes to ensure their independence is maintained including safeguards to ensure that where they do provide non-audit services, their independence is not threatened. They have written to the Audit Committee confirming that, in their opinion, they are independent.

#### **Remuneration Committee**

The Remuneration Committee comprises the independent non-executive Directors under the chairmanship of Baroness Hogg. 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. It is also responsible for determining the fees of the Chairman and the terms upon which the service of executive Directors is terminated having regard to a severance policy adopted by the Board. It also prepares for approval by the Board the annual report on Directors' remuneration (set out on pages 80 to 89).

The Committee meets periodically when required. Members' attendance record at meetings of the Committee in 2003 is given on page 78. No person other than the members of the Committee is entitled to be present at meetings but others may be invited by the Committee to attend. No Director nor the Company Secretary is present when the Committee considers matters relating to himself or acts in matters relating to himself.

The Committee has access to such information and advice both from within the Group and externally, at the cost of the Company, as it deems necessary. It is responsible for appointing any consultants in respect of executive Directors' remuneration.

#### **Nominations Committee**

The Nominations Committee comprises the non-executive Directors and the Chief Executive under the chairmanship of the Chairman of the Board (except when the Committee is dealing with the appointment of a successor as Chairman of the Board when the Senior Independent Director chairs the Committee).

The Committee leads the process for identifying and makes recommendations to the Board on candidates for appointment as Directors of the Company and as Company Secretary, giving full consideration to succession planning and the leadership needs of the Group. It also makes recommendations to the Board on the composition of the Chairman's and Nominations Committees and the composition and chairmanship of the Audit and Remuneration Committees. It reviews regularly the structure, size and composition of the Board, including the balance of skills, knowledge and experience and the independence of the non-executive Directors, and makes recommendations to the Board with regard to any changes.

The Committee meets periodically when required. Members' attendance record at meetings of the Committee in 2003 is given on page 78.

The Board has agreed the procedures to be followed by the Nominations Committee in making appointments to the various positions on the Board and as Company Secretary. These procedures, under which the Committee agrees a description of the role, experience and capabilities for a Director, are available on GKN's website. The Committee has access to such information and advice both from within the Group and externally, at the cost of the Company, as it deems necessary. This may include the appointment of external executive search consultants, where appropriate.

The procedures referred to above were used in the appointment during 2003 of Sir Christopher Meyer and Helmut Mamsch as non-executive Directors and for the appointment of Roy Brown as successor as Chairman with effect from May 2004. This included an assessment of the time commitment expected from the Director and, for the Chairman, recognising the need for his availability in the event of a major corporate action. Independent executive search consultants were used in connection with each appointment. Sir David Lees, as current Chairman, was not a member of the Nominations Committee panel which recommended to the Board the appointment of Roy Brown as successor to Sir David.

## CORPORATE GOVERNANCE CONTINUED

**Directors' attendance record**

The attendance of Directors at relevant meetings of the Board and of the Audit, Remuneration and Nominations Committees held during 2003 was as follows:

Director	Board (10 meetings)	Audit Committee (4 meetings)	Remuneration Committee (8 meetings)	Nominations Committee (6 meetings)
Sir David Lees <sup>(a)</sup> <i>Chairman</i>	10	3/3*	2/2*	6
Baroness Hogg <i>Deputy Chairman and Senior Independent Director</i>	10	4	8	6
<b>Executive Directors</b>				
Kevin Smith <i>Chief Executive</i>	10	–	–	6
Richard Clowes	10	–	–	–
Dick Etches	10	–	–	–
Ian Griffiths	9/10*	–	–	–
Neal Keating	10	–	–	–
Nigel Stein	10	–	–	–
<b>Other independent non-executive Directors</b>				
Roy Brown	10	4	8	6
Sir Ian Gibson	10	4	8	6
Helmut Mamsch <sup>(b)</sup>	1/1*	–	1/1*	1/1*
Sir Christopher Meyer <sup>(c)</sup>	4/5*	1/3*	3/4*	4/4*
Dr Klaus Murmann	7/10*	–	6/8*	5/6*
Sir Peter Williams	10	4	8	6

\*Actual attendance/maximum number of meetings Director could attend as a member.

**Internal control**

The Board attaches considerable importance to, and acknowledges its responsibility for, the Group's systems of internal control and risk management and carries out regular reviews 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, serious accidents or events having a major

commercial impact have arisen or any significant new risks have been identified, with subsequent reporting to the next Board meeting if appropriate.

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 32 to 41.) These processes are summarised in a 'risk map' which is reviewed at least 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 whether they have complied with 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 (whose members include the Finance Director of GKN plc) is responsible for the overview of the corporate governance procedures adopted by AgustaWestland that are appropriate to the business and comply with the requirements of both shareholders.

(a) Resigned as a member of the Audit Committee in November 2003 and of the Remuneration Committee in February 2003.

(b) Appointed 1 December 2003.

(c) Appointed 1 August 2003.