

## CORPORATE GOVERNANCE

A new Combined Code on Corporate Governance came into effect for UK listed companies for reporting years beginning on or after 1 November 2003. Following publication of the new Code, the Board reviewed its procedures with a view to complying with its detailed provisions during 2004. The following paragraphs, together with the report on Directors' remuneration on pages 79 to 87, provide a description of how the main and supporting principles of the Combined Code have been applied within GKN. The Directors' statement of compliance with the Code is given on page 78.

### 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 health and safety and environmental performance of the Group;
- approving appointments to the Board and to the position of 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.

The Directors' responsibility for the preparation of accounts is explained on page 73 (their confirmation that they consider it appropriate to prepare the accounts for 2004 on a going concern basis is given on page 30).

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.gkn.com](http://www.gkn.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 77 and 78. Descriptions of the specific responsibilities which have been delegated to the principal Board Committees are given on pages 75 to 77.

The Board currently comprises four executive and seven non-executive Directors including the Chairman. Biographical details of the Directors are given on page 41. 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 and the Board does not consider that there exist any relationships or circumstances likely to affect the judgement of any Director.

The Board normally meets 11 times a year, including at least one meeting at a Group operating company. Comprehensive briefing papers are provided to all Directors one week before Board meetings. During the year there are sufficient opportunities for the Chairman to meet with the

non-executive Directors without the executive Directors being present should this be deemed appropriate.

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.

The other significant current commitments of Roy Brown, Chairman, are listed in his biography on page 41. Mr Brown retired as non-executive Chairman of Thus plc in September 2004 and the Board is satisfied that his remaining commitments do not unduly restrict his availability to GKN and, in particular, would not do so in the event of GKN being involved in a major corporate transaction or other action.

### 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 executive Directors in relation to each individual business portfolio. Plant visits are organised as necessary for new 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.

Training and development of Directors in 2004 took various forms, including visits to GKN plants (both with the Board as a whole and on an individual basis), one-to-one briefings by GKN executives and external consultants, attendance by certain Directors at courses for non-executive Directors run by executive educational establishments, professional bodies and City solicitors, attendance at external training sessions and seminars on matters relevant to members of remuneration committees, an internal briefing on UK and EU regulatory developments, seminars facilitated by external audit firms on the forthcoming implementation of International Financial Reporting Standards and workshops run by external bodies on various commercial and regulatory matters.

### Performance evaluation

The effectiveness of the Board and of the principal Board Committees was evaluated during 2004, building on the in-house process first developed in 2002. The process involved each Director, as well as other attendees at relevant Board Committee meetings, completing a detailed questionnaire covering, inter alia, Board and Committee composition, arrangements for and content of meetings, Board objectives and Committee terms of reference, corporate governance

issues, visits to operating sites, access to information, and administrative procedures. The results of the evaluation and recommendations for improvements were reported to the relevant Committees before the Board as a whole agreed appropriate changes.

A number of improvements were identified for implementation as a result of the evaluations. These included:

- the formation of three sub-committees of the Executive Committee, covering operational excellence, technology excellence and governance and risk management, which involve senior management below Executive Committee level in these critical areas of the Committee's responsibilities (the terms of reference of these sub-committees are available on the GKN website);
- changing the arrangements for the review of Group and Divisional strategy by the Board;
- changing the procedures for updating the Board on major restructuring projects in the Group; and
- increasing the emphasis on corporate social responsibility issues at Board meetings and during Board visits to operating sites (the Group's social responsibility review is on pages 31 to 38).

The Chairman has conducted performance evaluations of the non-executive Directors (assessing in particular their contribution and commitment) and of the Chief Executive (taking into account the views of the other executive Directors and the non-executive Directors). To assist this process, a number of assessment areas were identified in advance and used as a framework for conducting the appraisal interviews. In the case of Sir Peter Williams, who completed his initial three-year term as a non-executive Director during the year, the evaluation provides the basis for the recommendation to shareholders set out in the Annual General Meeting circular enclosed with this annual report that he be re-elected at the forthcoming Annual General Meeting. Baroness Hogg, as Senior Independent Director, led the evaluation by the non-executive Directors of the performance of the Chairman, Roy Brown, taking into account the views of the executive Directors. No actions were considered necessary as a result of any of the evaluations.

#### **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 Annual General Meeting are given to shareholders in the Notice of Meeting circular.

#### **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.

The Chairman offers annually to major investors in GKN the opportunity to meet with him should they so wish to discuss matters relating to governance, including Directors' remuneration, and strategy. Feedback to the Board is provided by the Chairman on any issues raised with him. The Finance Director reports twice yearly to the Board on meetings with investors. These reports include summaries prepared by the Company's brokers on the market's reaction to results announcements and the

subsequent meetings between management and investors. External brokers' reports on GKN are circulated to all Directors and the Board is briefed periodically by external financial consultants on investor perceptions of GKN.

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 together with the level of abstentions, following each vote on a show of hands.

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.

#### **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 consists of the executive Directors together with the Group Human Resources Director 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.

As referred to above, during 2004 the Executive Committee established three sub-committees consisting of members of senior management:

- the Operational Sub-Committee, under the chairmanship of Ian Griffiths, Group Managing Director GKN Automotive, is responsible for monitoring and reviewing key elements that contribute directly to operational performance and the improvement of 'business health';
- the Technology Sub-Committee, under the chairmanship of Richard Clowes, Group Managing Director Corporate Development, is responsible for setting policy and providing guidance and direction in relation to technologies employed across all business areas, and provides input to the Executive Committee to contribute to the formulation of the Group's business strategy; and
- the Governance and Risk Sub-Committee, under the chairmanship of the Company Secretary, Grey Denham, is responsible for monitoring and reviewing matters relating to governance and compliance, risk management and corporate social responsibility.

#### **Chairman's Committee**

The Chairman's Committee consists of 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 consists of the independent non-executive Directors. Sir Peter Williams assumed the chairmanship of the Committee from Roy Brown at the conclusion of the Company's 2004 Annual General Meeting following Mr Brown's appointment as Chairman of the Board.

John Sheldrick, Group Finance Director of Johnson Matthey plc, who joined the Board in December 2004 and was appointed a member of the Audit Committee, has recent and relevant financial experience.

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, and makes recommendations to the Board on the appointment, reappointment or dismissal of the external auditors. It also reviews bi-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 (see page 78) and is responsible for approving, upon the recommendation of the Chief Executive, the appointment and termination of the head of that function. It also reviews periodically the Group's employee disclosure procedures policy which provides for employees to disclose, in confidence, instances of wrongdoing by other employees.

The Committee reviews annually its terms of reference and its effectiveness and recommends to the Board any changes required as a result of such review. Following the review in 2004, the Committee's terms of reference were amended to provide for a Committee member to contact the external auditors direct in circumstances where he or she considers it necessary.

The Audit Committee meets at least five times a year, including meetings before the annual and interim results announcements and at the planning stage of the annual external audit process. Members' attendance record at meetings of the Committee in 2004 is given on page 77.

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. 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. The Committee has independent access to the internal audit function and to the external auditors and both the head of internal audit and the external auditors have direct access to the Chairman of the Committee outside formal Committee meetings. The Chairman of the Committee has quarterly meetings and regular intervening contact with the head of internal audit and twice yearly formal meetings as well as ad hoc contact with the external auditors on specific matters.

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 purely consultancy nature. For other non-audit work, the policy is that GKN does not use the external auditor 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.

In 2004, the Audit Committee discharged its responsibilities by:

- reviewing the Group's draft 2003 preliminary annual results announcement and financial statements and 2004 interim results statement prior to Board approval (including consideration of the significant accounting judgements contained therein) and reviewing the external auditors' detailed reports thereon;
- reviewing the Group's trading update announcement prior to release at the Annual General Meeting;
- reviewing the appropriateness of the Group's accounting policies including changes necessary in the light of the proposed transition to International Financial Reporting Standards;
- reviewing regularly the potential impact on the Group's financial statements of certain matters such as impairments of fixed asset values and International Financial Reporting Standards;
- reviewing the effectiveness of the 2003 external audit process and recommending to the Board, after due consideration, the reappointment of the incumbent external auditors at the Annual General Meeting;
- reviewing the application of the Board's policy on non-audit work performed by the Group's external auditors together with the non-audit fees payable to the external auditors in 2003;
- reviewing compliance with the Group's policy on the employment of former employees of the external auditors;
- reviewing the external auditors' plan for the audit of the Group's 2004 accounts, which included key areas of focus, key risks on the accounts, confirmations of auditor independence and the proposed audit fee, and approving the terms of engagement for the audit;
- reviewing reports from the internal audit function and the external auditors on the Group's systems of internal control in advance of the announcement of the Group's results for 2003 (the internal report included a summary of and commentary on the annual detailed divisional reports on their business risks and internal control processes) and reporting to the Board on the results of this review, and reviewing interim updates prior to the half-year results;
- receiving regular updates from management on key financial control matters arising in the Group;
- reviewing a post-acquisition report on the integration and performance of a significant recent acquisition;
- reviewing the risks associated with a major business programme;
- reviewing the terms of reference, resources, performance and effectiveness of the internal audit function, its work programme for 2004 and quarterly reports on its work and findings during the year, and monitoring compliance by Group companies with its recommendations; and
- reviewing the results of the performance evaluation questionnaire (see page 74) as it related to the Committee and approving certain consequential changes to the Committee's procedures.

### Remuneration Committee

The Remuneration Committee consists of 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, and for monitoring the remuneration of senior managers just below Board level. It also prepares for approval by the Board the annual report on Directors' remuneration (set out on pages 79 to 87).

The Committee meets periodically when required. Members' attendance record at meetings of the Committee in 2004 is given opposite. 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, 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 consists of 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 keeps under review 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 2004 is given opposite. 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.

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 2004 of John Sheldrick as a non-executive Director. This included an assessment of the time commitment expected from the Director. Independent executive search consultants were used in connection with the appointment.

### Directors' attendance record

The attendance of Directors at relevant meetings of the Board and of the Audit, Remuneration and Nominations Committees held during 2004 was as follows:

Director	Board (12 meetings)	Audit Committee (7 meetings)	Remuneration Committee (8 meetings)	Nominations Committee (7 meetings)
Roy Brown <i>Chairman (from 20 May 2004)</i>	12	3/3*	4/4*	7
Sir David Lees <i>Chairman (until 20 May 2004)</i>	5/5*	–	–	4/4*
Baroness Hogg <i>Deputy Chairman and Senior Independent Director</i>	12	7	8	7
<b>Executive Directors</b>				
Kevin Smith <i>Chief Executive</i>	12	–	–	7
Richard Clowes	12	–	–	–
Ian Griffiths	12	–	–	–
Nigel Stein	12	–	–	–
Dick Etches <sup>(a)</sup>	6/6*	–	–	–
Neal Keating <sup>(b)</sup>	4/6*	–	–	–
<b>Other independent non-executive Directors</b>				
Sir Ian Gibson	11/12*	6/7*	6/8*	5/7*
Helmut Mamsch	9/12*	5/7*	5/8*	4/7*
Sir Christopher Meyer	10/12*	4/7*	7/8*	6/7*
Sir Peter Williams	12	7	8	7
Dr Klaus Murmann <sup>(c)</sup>	4/5*	–	3/4*	3/4*

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

(a) Retired 30 June 2004.

(b) Left service 30 June 2004.

(c) Retired from the Board 20 May 2004.

(d) Mr J N Sheldrick was appointed a non-executive Director on 20 December 2004. No Board or Committee meetings were held in 2004 following his appointment.

### Internal control

The Board attaches considerable importance to, and acknowledges its responsibility for, the Group's systems of internal control and risk management and receives regular reports on such matters.

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. To assist with this process the Executive Committee established during 2004 a Governance and Risk Sub-Committee. There is a standing agenda item at every Executive Committee meeting to enable its members 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 and/or Audit Committee if appropriate.

Continuing processes under the oversight of the Governance and Risk Sub-Committee are in place for all parts of the Group to assess the major risks to which their operations are exposed and the way in which such risks are monitored, managed and controlled. The risks covered by these processes include those relating to strategy, operational performance, finance (including risk financing and fraud), product engineering, business reputation, human resources, health and safety, and the environment. 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, 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.

The objective of the Group's risk management processes is to ensure the sustainable development of GKN through the conduct of its business in a way which:

- satisfies its customers;
- develops environmentally friendly products and processes;
- provides a safe and healthy workplace;
- protects against losses from unforeseen causes;
- minimises the cost and consumption of increasingly scarce resources;
- prevents pollution and waste;
- maintains proper relationships with our suppliers and contractors; and
- maintains a positive relationship with the communities in which it does business.

The Group Risk Management Council (which replaced the Group Loss Prevention Council during 2004) acts as a steering group for loss prevention and certain sustainable development activities across Group operations. The Council is under the overall supervision of the Governance and Risk Sub-Committee referred to above.

The Group's interest in its major 50:50 joint venture, AgustaWestland, formed in 2001 when GKN and Finmeccanica merged their respective helicopter manufacturing businesses, was sold on 30 November 2004. Until the disposal, the Finance Director of GKN plc was a member of the AgustaWestland Audit Committee responsible for the overview of the corporate governance procedures adopted by AgustaWestland which were appropriate to the business and complied with the requirements of both shareholders.

The Group's systems and procedures are designed to identify, manage and, where practicable, reduce and mitigate the effects of the risk of failure to achieve business objectives. They are not designed to eliminate such risk, recognising that any system can only provide reasonable and not absolute assurance against material misstatement or loss.

### **The review process**

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

- setting 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, major contracts 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 at least annually a review of the Group's pension fund arrangements and insurance and risk management programmes;
- receiving two reports each year, following their review by the Executive Committee, on environmental, health and safety performance of the Group's operations. From 2005, the reports will be extended to cover all corporate social responsibility matters; and
- reviewing at least annually management development and succession plans. The Executive Committee also reviews management development issues twice a year.

The Board receives an annual report from the Audit Committee concerning the operation of the systems of internal control and risk management. This report, together with the reviews by the Board during the year of the matters described above, enables the Board to form its own view on the effectiveness of the systems.

The Audit Committee is responsible for reviewing the ongoing control processes and the actions undertaken by the Committee during 2004 to discharge this responsibility are described on page 76. To assist it in this role the Committee liaises closely with the internal audit department. This department has a risk-based work programme and its purpose is to review and test the systems, controls, processes, procedures and practices across the Group. The head of internal audit reports directly to the Group Chief Executive and the department's reports are seen by the relevant members of the Executive Committee. The resolution of any control issues raised by Board members or in reports reviewed by the Audit Committee are discussed in Committee with management.

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 appended to the Combined Code on Corporate Governance (the Turnbull Guidance), have been in place throughout that period and up to the date of approval of the annual report.

### **Compliance with the Combined Code**

Throughout 2004, GKN was in compliance with the relevant provisions of the Combined Code on Corporate Governance, except with regard to the following aspects:

#### **Audit Committee membership**

The Audit Committee did not have a member with 'recent and relevant financial experience' as required by the Code until the appointment of John Sheldrick, Group Finance Director of Johnson Matthey plc, who joined the Board as a non-executive Director and became a member of the Audit Committee on 20 December. Sir David Lees, who was a former Finance Director of GKN, acted as an adviser to the Committee until his retirement as Chairman of the Board in May 2004.

#### **Board balance**

As a consequence of the changes to the Board described in the Directors' report on page 72, for a period of approximately six weeks following the Company's Annual General Meeting in May less than half the Directors were independent non-executive Directors.