



Institute of Internal Auditors
UK AND IRELAND

Mr Chris Hodge
Corporate Governance Unit
Financial Reporting Council
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Sent by email to: codereview@frc.org.uk

5 March 2010

Dear Mr Hodge

Consultation on the revised UK Corporate Governance Code – December 2009

The Institute of Internal Auditors is delighted to have this opportunity to provide our views on the proposed changes to the UK Corporate Governance Code.

Please find attached our comments. We hope you will find them constructive and we would be happy to discuss any of them in more detail. We are content for our comments to be considered as part of the public record.

Yours Sincerely

Dr Ian Peters
Chief Executive

Introduction

The Institute believes that the changes proposed for the Code of Corporate Governance (the Code) will clarify the needs of good governance. We have identified three issues that are of particular import and where we would recommend improvements. These are:

- The accountability of the board for risk, not just for the processes related to risk.
- Internal audit's contribution to good governance.
- The effect on the quality of governance of audit firms providing non-audit services.

We expand below on these points in more detail and, in addition, provide several other comments on the proposed draft.

Key issues

Accountability of the board for risk

We welcome your intention to put risk and its management firmly on the board agenda. However, we note that the current additions to the Code focus very much on creating due process rather than on taking responsibility for the organisation's risks.

We would prefer to see a clear statement that the whole board is accountable and responsible for the governance of risk. This would be more appropriate as the main principle at C2, with the current proposed principle being made into two supporting principles:

“C.2: Risk Management and Internal Control

Main Principles

[The board is responsible and accountable for the governance of risk.](#)

[Supporting Principles](#)

The board is responsible for defining the company's risk appetite and tolerance.

The board should maintain a sound system of risk management and internal control to safeguard shareholders' investment and the company's assets.”

On page 4 below, we recommend a further change to C.2. that is unrelated to this point about the governance of risk.

In addition, we believe that it is important to emphasise that risk-taking and the managing of risks are activities that form an essential part of the direction of the company, as well as of its control. Therefore, we believe there should be some form of reference to risk in the statement of the role of the board in Section A.

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Extract from A.1: The role of the board

Main Principle

Every company should be headed by an effective board which is collectively responsible for the long-term success of the company.

Supporting Principles

The board's role is to provide entrepreneurial leadership of the company within a framework of prudent and effective controls which enables risk to be assessed, [taken](#) and managed. The board should set the company's strategic aims, [establish the nature of risks the company will take](#), ensure that the necessary financial and human resources are in place for the company to meet its objectives and review management performance. The board should set the company's values and standards and ensure that its obligations to its shareholders and others are understood and met.

Recognition of internal auditing as component of good corporate governance

The Institute believes that professional internal auditing is a cornerstone of good governance. A properly resourced internal audit function is a valuable source of information for the board to assist it in its role of constructively challenging the development of strategy, including scrutinising performance and monitoring the integrity of financial information (as stated in Principle A4).

Currently, the Code recognises the need for internal audit but treats it very differently from every other element that contributes to good governance. We recommend that the Code is now amended to include a clear provision that the company should have a professional internal audit function. This is particularly important for internal audit since it is not a statutory requirement. As with all other provisions, the company will be able to explain why it does not comply if it does not believe it needs internal audit.

Currently, the Code refers to internal audit only in section C.3., related to the Audit Committee. It is appropriate that the Audit Committee oversees the internal audit function and that, therefore, C.3. continues to contain provisions relating to that oversight. However, modern internal auditing's scope is very broad and is intimately related to the information that the board needs, as explained above. Therefore, we are proposing a new provision within the B.5. section of the Code.

We recommend the following:

B.5.3. The board should ensure that the company has a professional internal audit service providing objective and independent assurance to the board and senior management by evaluating and helping to improve governance, risk management and internal control.

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Relationship between internal auditors and the company's external auditor

In your introductory document, you refer to the review by the Auditing Practices Board (APB) of the issue of non-audit fees. We have provided a detailed paper to the APB on the topic of audit firms providing internal audit services to their external audit clients. Our conclusion is that this practice may compromise the quality of both internal audit and governance, as well as the independence of the external auditor.

We believe, therefore, that the Code should provide some guidance to reflect the idea that it is better for the standard of corporate governance in the UK and Ireland if audit firms do not provide both external and internal audit services to the same companies.

It is likely that the most appropriate place for this reference is in section C.3. and, particularly, in the provisions related to overseeing external auditor independence and internal auditor independence. It may also be useful to provide further information in the *Guidance for audit committees* document.

We note that these issues are unlikely to be addressed before the APB moves ahead with its main review but we offer the feedback for you to consider when appropriate. We will be happy to provide suggested wording and to discuss this further, if it is helpful.

Redrafting of Section C

We believe there have been some useful changes in this section, including the changes to the headings, which are improvements. However, there are several examples where the wording of provisions is not consistent with the new wording proposed in the draft.

C.1. – although the heading has changed, the provisions still focus on financial reports. We recommend adding a supporting principle – or adding to the existing one – text that refers to “other non-statutory reporting from the company to shareholders and other stakeholders”.

C.1.2. – we support the proposed disclosure and agree that it makes no sense to have this statement separate from the disclosures on risks. They are part of a whole and should be together.

C.2. – as noted above, this is where we believe it is appropriate to put something more explicit about the board being responsible for the risks. In addition, the new wording leaves the system of risk management and internal control with far too narrow a purpose. Its role is not just to safeguard the investment and assets but also to achieve the objectives of the organisation. We recommend the following:

Main Principle

The board is responsible and accountable for the governance of risk.

Supporting Principles

The board is responsible for defining the company’s risk appetite and tolerance.

The board should maintain a sound system of risk management and internal control to achieve the company’s objectives and to safeguard shareholders’ investment and the company’s assets.

C.2.2. – we suggest that this needs to be consistent with the wording in the principles in order to avoid confusion. We propose:

C.2.2. The board should, at least annually, conduct a review of the effectiveness of the company’s system of risk management and internal controls and should report to shareholders that they have done so. The review should cover all material ~~controls~~risks, including, but not limited to, financial, operational and compliance ~~controls and~~risk management systems.

C.3. – given that this section deals with the audit committee’s role of oversight, this is an alternative place for the provision related to the need for internal audit.

C.3.2. – this provision explains the responsibilities of the audit committee and the second bullet should reflect the new wording re: the system of internal control. We also recommend that it is split to reinforce the idea that section C is dealing not just with financial issues. We propose:

- to review the company’s internal financial controls;
- ~~and~~, unless expressly addressed by a separate board risk committee composed of independent directors, or by the board itself, to review the company’s system of risk management and internal control ~~and risk management systems~~;

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C.3.2— in order to parallel more appropriately the provisions related to external audit, the third bullet should include the following responsibilities:

- to monitor and review [the independence and objectivity of the company's internal audit activity, the results of its work and its ~~the~~ effectiveness of the company's internal audit function](#);

C.3.4. – We recommend that the arrangements should be not just for staff of the company but also for others with a relationship with the company, eg suppliers, customers, contractors, etc

C.3.5. - Again, in order to parallel more appropriately the provisions related to external audit, this provision should include a clearer statement of responsibilities, which we believe are current good practice for audit committees. We propose:

C.3.5. The audit committee should [have primary responsibility for appointing and removing the head of internal audit and should act at all times to support the organisational independence of the internal audit activity. . . The audit committee should approve the internal audit charter and the risk based internal audit plan and](#) monitor and review the effectiveness of the internal audit activities. Where there is no internal audit function, the audit committee should consider annually whether there is a need for an internal audit function and make a recommendation to the board, and the reasons for the absence of such a function should be explained in the relevant section of the annual report.

If the new provision (page 2 above) recognising internal audit as an element of good governance is adopted, the second sentence of provision C.3.5. – starting “Where there is no internal audit ...” – may be deleted.

C.3.7 – throughout the rest of C.3. the provisions distinguish between internal and external audit. We propose to bring C.3.7 into line with this usage. There are two alternative treatments, the first showing the minimum necessary changes. The second recognises that, in some cases where the external auditor provides non-audit services, the independence of the internal auditor may also be compromised.

Either: The annual report should explain to shareholders how, if the [external](#) auditor provides non-audit services, [external](#) auditor objectivity and independence ~~is~~ [are](#) safeguarded.

Or: The annual report should explain to shareholders how, if the [external](#) auditor provides non-audit services, ~~auditor the~~ objectivity and independence [of the internal and external auditors are](#) ~~is~~ safeguarded.”

Drafting and other comments

The following comments include small drafting points and less significant points of substance. They are presented in the order of, and by reference to, the headings firstly of the consultation document and then of the draft Code.

Structural changes

We agree with the change of name.

We believe that the reorganisation of section A into sections A and B is very well done.

We agree with the removal of section E as long as the Stewardship Code is adopted.

We agree with the removal of Schedule B.

Proposed changes by principle

In general, we think the changes are all good. We have not attempted to quantify how much they cost in time and money. We believe it should be possible for organisations to find ways that are appropriate to their size and resources to apply the principles and comply with the provisions.

Disclosure requirements

You suggest allowing companies to put a full Corporate Governance report on their web sites, with a shortened version in the Annual Report. As long as companies do not exploit this change as a way to reduce the overall disclosures and it is a practical solution, we support this.

Preamble to the Code

The opening paragraph appears to restrict companies so that they have only the objective of delivering shareholder value. We believe that the Code should not do this. The board must set the organisation's objectives. We propose that the opening sentence should be: "The purpose of corporate governance, supported by the Code, to facilitate the long term success of the company."

We do not entirely agree with the principles of governance that you identify in paragraph 5. We do not see objectivity as a fundamental principle of governance and recommend that you omit it in future. Instead, we would like to see the principle of "probity" included. This principle is usually discussed with accountability and transparency; and it is implied by new supporting principle in A.1.

We believe your focus in paragraph 5 on the sustainable success over the long term is a good addition but its inclusion emphasises the problems with the opening paragraph. The two paragraphs should be consistent with each other.

Main Principles

We think that presenting the main principles in one place as you have proposed is an improvement to the Code.

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Section A

We agree with all the proposed principles and supporting principles in A

We note that the second supporting principle in A.1. implies the need for “probity” as a fundamental principle.

Section B

Principle B.1. is an improvement.

Given the general agreement over the last year that we should support good behaviours on the part of board directors, we suggest adding to the phrase “balance of skills, experience, etc” a reference to personal attributes such as courage, capacity to challenge a status quo and tenacity. These are essential for directors to be able to fulfil the duties outlined in A.4.

B.1. supporting principle in paragraph 2 reads poorly. We suggest that you revert to the previous form: “There should be a strong presence on the board of executive etc.”

B.2. – we agree with all the changes but, again, in B.2.2. we propose you add, “personal attributes”.

B.3. – we agree with this principle. This is the only place in the principles that you use the word “must”. Is it intentional?

B.4. – we agree with the principles and provisions. However, B.4.1. has now lost the idea of offering to shareholders the opportunities to meet directors. We comment on this further below in relation to section E.

B.5. – we agree with this provision. As proposed above, this is an appropriate place to refer to the internal audit activity since assurances and other reporting from internal audit should be a source of good information in addition to management information.

B.6. – we agree with this provision.

B.6.2. – the idea of external facilitation is a good one. The wording of the second sentence, adapted from D.2.1. as it is, is wrong in this context. External facilitation has to be undertaken by people from outside, by definition. It will be helpful to shareholders if the independence of the facilitators is disclosed, whether or not those facilitators are consultants. We propose the following change:

B.6.2. Evaluation of the board should be externally facilitated at least every three years. ~~Where consultants are used~~ A statement should be made available of whether the external facilitator(s) has they/ have any other connection with the company.

B.7. – we agree with the principle that directors should be seen to hold themselves up to account on a regular basis. We have no strong view between the alternatives proposed.

Section D

In general, we agree with this section.

D.1. supporting principle para. 1 – this requires the performance-related elements of their remuneration to align the interests of directors with “those of the shareholders and to promote the long-term success of the company.” The interests of the shareholders and the long-term success of the company may not be the same things. Therefore, you are suggesting establishing a performance-related system that contains potentially conflicting demands. There has to be a balance between the two and, in fact, one objective may need to be recognised as more important than the other.

Section E

In general, we agree with this section.

E.1.1. Given the loss of the part of provision B.4.1. that required companies to offer to shareholders the opportunity to meet directors, we suggest the wording of this provision be made clearer. Split the sentence about non-executive directors attending meetings into 3 elements:

1. Non-executive directors should be encouraged to attend existing meetings with shareholders such as AGMs and appropriate briefings.
2. The company should use existing communications – not special purpose ones – to shareholders – the web site, the annual report, etc – to offer them a chance to meet directors.
3. Directors should expect to attend meetings where shareholders have asked to meet them.

- ENDS -