



BAKER TILLY

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Dear Mr Hodge

Review of the impact of the Combined Code - Response of Baker Tilly

Overview – corporate governance in practice

Baker Tilly welcomes the opportunity to respond to the FRC's review of the impact of the Combined Code ("the Code"). Baker Tilly strongly supports the overall ethos of the Code and we recognise that it has made a significant contribution to enhancing the effectiveness of the UK's corporate governance framework. We also acknowledge that the introduction of the 'comply or explain' approach has been successful in further promoting constructive and timely communication between companies and investors and for raising the overall quality of disclosure in financial statements.

However, whilst appreciating that there is consensus amongst stakeholders for the overall corporate governance principles of responsibility, accountability, transparency and fairness, our view is that a 'one size fits all' approach to corporate governance is not appropriate. The extent to which the ever-increasing burden of well meaning regulation truly leads to greater insight and transparency into a company's management and performance, as well as providing an effective means for detection of the rare instances of corporate wrongdoing, is a matter of debate. This regulatory hammer is a significant issue for smaller listed companies or those companies whose operations are relatively simple, to crack the well meaning compliance nut. Smaller entities are generally exposed to fewer or more manageable risks and thus their annual reports should reflect this. The costs of full compliance with the Code often outweigh the benefits in such circumstances.

Further, the overall effectiveness of the Code is dependant upon numerous human factors in the interpretation and communication of the regulatory demands i.e. the spirit in which companies and investors approach compliance and investor relations. Companies, in an attempt to develop best practice in the governance arena, should not be drawn into thinking that non-compliance with the Code is deemed as failure. This is of course only the case so long as a departure from the 'comply' principle is fully 'explained'. Companies must be encouraged to steer away from 'boiler-plate' disclosure and adopt bespoke arrangements that are deemed to be appropriate and robust for the company. Comprehensive communication of these arrangements to



investors is vital. This will ensure that 'value-adding' information is released and compliance costs managed.

Ultimately, effective corporate governance is a key element in enhancing investor confidence, promoting competitiveness, and improving economic growth. The challenge for policy-makers, companies and investors alike is to approach such compliance in the right spirit:

- Policy-makers must ensure a balanced approach to legislative and regulatory reform that adequately considers evolving global practice to promote enterprise to maintain and enhance shareholder confidence; and ultimately to stimulate investment.
- It is vital for companies to adopt, and to be recognised as adopting, good corporate governance, particularly in light of recent high-profile corporate scandals and increased investor activism. Good corporate governance should reflect tailor-made, robust policies that fully reflect the spirit of the Code as well as other mandatory regulatory and legislative rules. Further, companies must be prepared to explain their approach and importantly, justify their position for non-compliance with the Code.
- Investors must be prepared to engage with companies and educate themselves in the culture and processes of the company, including the reasons for particular departures from the Code. Adopting a checklist compliance approach to a company's governance arrangements is unlikely to result in investors truly understanding the company.

Issues for comment

1. Does the code support better board performance over time?

When the revised version of the Code was issued there were fears "that an emphasis on monitoring and the burden of process would undermine the unitary board, distract the board from strategy and inhibit risk taking." However, many boards have embraced the underlying philosophy of the Code and have recognised the need to interpret the Principles of the Code to ensure appropriate application. Further, the Code has provided a valuable barometer to assess the effectiveness of a company's governance arrangements over time and against others. This said, the issue of boilerplate reporting still raises concern

As stated previously, in an attempt to strengthen its corporate governance reporting, companies often look to assimilate so called 'best practices'. Such a need may arise due to companies not having adequate knowledge or resource to deal sufficiently with the requirements of the Code; they do not wish to be seen to be veering too much away from the 'Comply' aspect; or compliance/conformist pressure is being exerted by investors. However, in today's complex and evolving environment where corporate culture, financial reporting issues and governance needs can vary dramatically between companies, a 'one size fits all' approach is not deemed suitable. Further clarity on the Main and Supporting Principles and appropriate application of



them, would help to strengthen the governance framework within a company as well as encourage more tailored reporting resulting in greater transparency and understanding for investors. More frank and less boilerplate disclosure would also assist in emphasising and encouraging improvements in board performance over time.

2. Is the “comply or explain” approach working effectively?

We support the Code’s ‘comply or explain’ approach and believe that in principle it does facilitate effective and flexible governance and reporting by companies. Ultimately, the Code should be seen as supporting the board in its role to provide entrepreneurial leadership to the company. One of the tests that can be used to assess this is to measure whether the company’s corporate governance policies have helped to create shareholder value. However, in order for this approach to work effectively, it does require the following:

- Companies must think carefully about whether departures from the provisions’ of the Code are appropriate to their particular circumstances. If so, a company must ensure it provides meaningful explanations of why it has taken that course of action.
- Investors must be prepared to accept departures from the Code so long as the explanations offered by the company are fully supportable and transparent.

We believe that the approach is generally working well in practice, particularly where there is timely and comprehensive dialogue between the company and its investors – usually before the annual report is issued – to discuss the company’s corporate governance policy and reasons for non-compliance. However we recognise that situations can arise which deter companies from ‘explaining’ departure from the Code (e.g. investor pressure to ‘comply’ or lack of resource to adequately deal with the ‘explain’ route) and they submit into ‘complying’ thus converting the ‘comply or explain’ mechanism into a tick-box exercise. Such pressure is most apparent in smaller companies. To address this, a company’s advisers should be encouraged to provide effective support and explanation and directors should be encouraged to educate investors and other stakeholders of the benefits and suitability of departure from the Code.

3. What impact has the Code had on smaller companies?

We firmly believe that quality governance is as important for a small company as it is for a big company. However, we are of the opinion that quality governance may not translate into being identical for both. It is not unreasonable to assume that the overall regulatory burden generates a proportionately greater time and cash cost for smaller companies. Further, for many such companies the cost is likely to be disproportionate to the benefits e.g. low investor interest/churn. In an attempt to balance this issue, smaller companies, particularly in the absence of investor demands, may actually resort to ‘boilerplate’ reporting to address the provisions of



'comply or explain' despite departure resulting in more meaningful and transparent information.

The main focus of a board should be to set and oversee the company's strategy. The board should primarily be focused on tasks that increase shareholder value. However, directors of smaller companies are increasingly concerned that dealing with governance matters, as well as the ever-rising regulatory burden, is becoming an increasingly onerous task. In order to alleviate this issue the creation of a corporate governance regime for smaller companies is desirable. This should detail the mandatory minimum compliance requirement, which, if attained, would result in achievement of corporate governance objectives not too dissimilar to those in place for larger companies but importantly, would be more appropriate for a smaller company. In short, prioritisation of the Principles of the Code is necessary.

4. Do disclosures on the Combined Code in annual reports provide useful information to shareholders at proportionate cost to companies?

Those companies that are well manned, organised and have strong investor relations should generally be suitably placed to deliver a comprehensive and tailored corporate governance report and Combined Code disclosures. That is, they should be able to deliver value-adding disclosures on the Code which satisfy the regulator and investors at a cost that is proportionate to the benefits accruing to the company.

In reality, the quality and extent of disclosures on the Combined Code vary and are more dependant upon the readiness and appetite of the directors to embrace the Code as opposed to paying lip service to it in order to meet regulatory requirements and the expectations of their investors. If such disclosures are viewed as a mechanistic exercise integral to the production of the annual report it is conceivable that a tick-list and boilerplate approach is more likely to be adopted. This may satisfy both undemanding shareholders and regulatory compliance but is ultimately less effective in ensuring that sound corporate governance is embedded within businesses. As discussed previously, the quality of information provided is ultimately dependant upon stakeholders approaching compliance with the Code in the right spirit. Companies need to embrace the Code, and its directors, as custodians, need to employ truly independent thinking to adopt the most appropriate approach to governance and disclosure, which may not necessarily be that which is easiest or most cost effective. Likewise, shareholders must be prepared to engage with the company; allow explanations a proper hearing, and be prepared to challenge the directors if they believe sub-optimal or inaccurate reporting is contained within the annual report.

The situation for smaller companies is likely to be different and has been explained in previous sections of this paper, particularly our response to question 3.

A handwritten signature in black ink, appearing to read 'Chris Hodge', written over a horizontal line.

Baker Tilly UK Audit LLP