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Dear Mr Hodge

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## INTRODUCTION

1. Ernst & Young LLP is grateful for the opportunity to offer its comments on the FRC's review of the Combined Code, in terms of its impact on corporate governance in the UK.
2. We agree with the findings of the FRC's review of the Code in 2005, which said that 'overall, the Code was bedding down well and having a positive impact, contributing to improvements in corporate governance practice and disclosure and greater engagement between boards and shareholders'. However, we believe it is admirable to review the Code periodically and we accept the need to assess its effectiveness for the longer term.
3. We have two overall observations to consider in a wider context, which we outline before commenting on the FRC's specific questions.

## GENERAL COMMENTS

4. At this time, Ernst & Young encourages the FRC to first reconsider how the Code is promoted to companies and used by shareholders, before seeking ways to modify its content, structure or form. This is because the current Code was only introduced in June 2006 following an extensive review of its predecessor the year before. The 2006 Code is well respected globally and seems to work well for the majority of those who use it.
5. In addition, we believe that significant changes to the Code may be counter-productive and a distraction at a time when the business community is addressing changes introduced by Sarbanes Oxley, IFRS, the 4<sup>th</sup>, 7<sup>th</sup> and 8<sup>th</sup> Directives and the Companies Act 2006, etc.

## RESPONSES TO YOUR SPECIFIC QUESTIONS

### 1. Does the Code support better board performance over time?

Yes. We believe the Code has contributed towards an overall improvement in the performance of UK boards by providing clarity and accountability, in regards to their role and responsibility to govern. However, the impact of effective governance on improved performance is difficult to measure because the terms used are relative and to some extent qualitative. For example, a profitable company can be led by a strong board which does not comply with the Code, and vice versa.

Good governance does appear to have an impact on financial reputation. However, we believe there is an opportunity for the FRC to promote the link between financial reputation and compliance with the Code, which might help to deter some boards from applying the Code superficially. We noted that the ABI (representing 20% of UK shareholders) conducted an assessment in February 2007<sup>1</sup> which indicated that poor corporate governance had a material impact on share price.

Other findings referenced in the consultation paper suggest that some boards may be distracted by the Code, and end up following it by the letter rather than the spirit. In this regard we believe there are two important initiatives that the FRC is best placed to undertake to help promote and protect the inherent flexibility of the Code. Firstly, we suggest that chairmen should be continually reassured that “non-compliance”, if justified and explained clearly and concisely to investors, is acceptable and perhaps on occasions encouraged. Secondly, investors should be encouraged to read these explanations and accept them as evidence of careful judgement and, in effect, a means of “compliance” and greater transparency.

### 2. Is the ‘comply or explain’ approach working effectively?

Yes, on the whole. Recently Heidrick & Struggles<sup>2</sup> analysed the reports and accounts from 320 top European companies and found that all of the UK companies complied with the Code and were rated as the best-governed companies in Europe.

However, our experience indicates that in some cases compliance is achieved through the adoption of a boilerplate that does more to “tick the compliance box” than improve the company’s governance model. A more effective approach in these circumstances would be to focus on the objective of the particular provision of the Code and explain why compliance with that provision would not advance the company’s drive for strong and cost effective governance.

Separately, some of the provisions of the Code may prove to be more important than others from a shareholder’s perspective. The Code has expanded considerably over the years and there may be an opportunity to rationalise some areas to save costs without compromising the overall benefits of the Code.

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

Your references to this question mention ‘proportionately higher compliance costs for smaller companies...bearing in mind the frustrations of comply or explain’. We believe that the Code

<sup>1</sup> ‘Price link to standards’, an article published by the FT on 19 February 2007.

<sup>2</sup> Heidrick & Struggles, ‘Corporate Governance in Europe’, referenced in an article by the Financial Times ‘The UK leads the pack’ published on 29 March 2007.

may be too onerous for the smallest companies, but we are not sure if there is a better alternative for external investors. We believe that the principles of good corporate governance should apply equally to all boards, regardless of the size or type of company they manage.

There are examples however where categories of small company (for example mutual insurers) have created and subsequently complied with an annotated version of the Code that is more appropriate for their operations and sector. We think there may be merit in this approach, so long as investors understand, accept, and can make use of the compliance reports and explanations.

More generally, if there is an issue for smaller companies regardless of sector, we expect it will be the requirement (as stated in the 8<sup>th</sup> Directive) for individual non-executive directors to possess "competence in accounting and/or auditing". In our opinion the greater number of smaller companies, and finite number of individuals who meet this criteria, could make the recruitment of non-executives a particularly challenging issue for smaller businesses. Therefore, we believe this requirement should be aggregated for smaller companies, so it can be met collectively by the audit committee, rather than by individual non-executives. We understand that the FRC may be discussing this option with the DBERR.

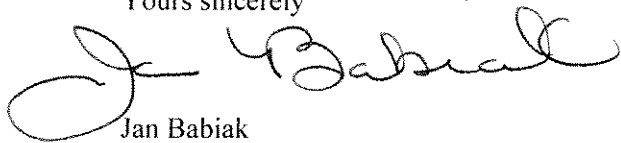
**4. Do disclosures on the Combined Code in annual reports provide useful information to shareholders at proportionate cost to companies?**

The cost of disclosures should be relatively immaterial in relationship to the cost of implementation and operation of the actions outlined in the disclosure. Hopefully the feedback from this consultation will give more insight from shareholders on their preferences for Combined Code disclosures. This can then be used to inform companies on the relevance of their current disclosures, and guide them towards changing future disclosures so they are more in line with shareholders' expectations.

**CONCLUSION**

6. Evidence suggests that the Code works well for the most part, and it is highly regarded overall by the UK business community and overseas regimes. Also, with so much else happening in reporting, auditing and governance, significant changes other than perhaps some rationalisation of the Code would be an untimely and potentially counter-productive distraction.
7. Therefore, Ernst & Young encourages the FRC to focus its efforts, first and foremost, on promoting the Code in its current form without making any substantive changes. To encourage more companies to 'comply and explain' in a way that is more beneficial to a wider range of shareholders.
8. We hope our responses are helpful. If the FRC would like further clarification on any of the points raised by Ernst & Young, please contact me. We wish you every success as you consider the market's response to this consultation.

Yours sincerely



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