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Our Ref NJJ/SAM/0407
Your Ref CODE REVIEW

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For the attention of Chris Hodge

20 July 2007

Dear Sirs

REVIEW OF THE IMPACT OF THE COMBINED CODE

We welcome the opportunity to respond on the above review paper. We support the approach taken by the FRC in seeking views from stakeholders, and we support initiatives to facilitate debate and discussion on issues relating to corporate governance.

Grant Thornton is a large financial advisory/accountancy firm in the UK. We are the UK member of Grant Thornton International, one of the world's leading international organisations of independently owned and managed accounting and consulting firms, which operate in 113 countries employing over 25,000 people worldwide.

We believe that in general, the Combined Code enjoys widespread support from all stakeholder groups, and that "comply or explain" is proven to have achieved tangible improvements in corporate governance practices of UK public entities. This is supported by Grant Thornton's annual Corporate Governance Review which we refer to in the appendix.

In our view the Code should remain substantially untouched, although we believe that audit committees would benefit from additional guidance in certain areas. Best practice for audit committee reports has moved on in recent years, particularly on assessment of auditor effectiveness, and with accounting and auditing judgements. In addition, there were certain recommendations made by the Market Participants Group in their interim report.

The one area where the comply or explain approach might need further consideration concerns new issues of non UK domiciled entities. Comply or explain has served the UK capital markets well, but in part this relies upon its application by management and non executives who are familiar with the UK reporting governance environment. We do not believe that there is yet sufficient evidence to warrant changes to the Code specifically to address non UK domiciled entities but we do believe this is an area the FRC should keep under review.

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Guidance for audit committees on assessment of auditor effectiveness

A key role of the audit committee is to make recommendations to the board on auditor appointment. Increasingly, the auditor selection decision is one that attracts attention from investor groups who want to know how the audit committee reached their decision, and why the appointed audit firm is the right choice for the company.

Whilst auditor selection is highly important, just as important is ongoing assessment of the effectiveness of the audit process, and assessment of the effectiveness of the auditor.

Guidance for audit committees on accounting and auditing judgements

Another area where we believe audit committees would benefit from specific guidance would be on what to disclose in their section of the annual report about judgements that the board made in approving the annual financial statements. International Accounting Standard 1: Presentation of Financial Statements (IAS 1) requires disclosure of judgements and estimates. IAS 1.113 requires directors to make disclosure of judgements made by management in applying the entity's accounting policies, and IAS 1.116 requires directors to make disclosure about key assumptions concerning the future, and key sources of estimation uncertainty. So in this regard audit committees would welcome guidance on assessing the process for, and extent of disclosure made in the financial statements of, those judgements.

Other areas of judgement not addressed by IAS 1 are choice of accounting policy, going concern assumption, audit judgements and risk assessment. Modern accounting standards are founded on principles. There are rules, but not every circumstance is addressed by an accounting rule, so directors and auditors apply judgement by applying principles. Judgements are subjective, and investors want to know more about how the directors conclude in situations where a range of answers is supportable.

Common areas of judgement include assumptions such as mortality rates in pension liability calculations; when to recognise revenue where the company provides services over a period of time; discount rate and interest rate assumptions in areas such as impairment reviews and financial instruments.

At present, investors know nothing about the discussions between the audit committee and the auditor on matters of judgement. They see no difference in reporting between a company where the accounting and the audit is straightforward, and a company where transactions are complicated, or subjective audit conclusions have been reached. There is evidence to suggest that investors would value more information in order to bridge this apparent gap in the knowledge of the financial reporting process and judgements made.

Areas of subjectivity need careful consideration by the audit committee. If subjective disclosures are not properly communicated by the board, or are not properly understood by investors, there could be adverse yet unwarranted share price movements. Investors want better disclosure in this area, but audit committees will need guidance on what to say and how to say it.

Users of financial statements have raised concerns about the length of accounts prepared using IFRS, and many observe that the audit committee report could act as a signpost to direct the attention of readers to key matters.

The report of the audit committee has been the subject of debate over recent months, including at the Audit Quality Forum. Some investors, but not all, would like the opportunity to vote on the report of the audit committee. A vote might discourage meaningful disclosure, but either way it is clear that all investors would like to know more about judgements and so audit committees will need help in working out what to say and how to say it.

Interim recommendations from the Market Participants Group

The Market Participants Group (MPG) released its interim report into Choice in the UK Audit Market in April 2007, making a package of interim recommendations. Those recommendations included:

- recommendation 7 - "The FRC should provide independent guidance for audit committees and other market participants on considerations relevant to the use of firms from more than one audit network. (A.2.3, pages 30-31)"
- recommendation 8 - "The FRC should amend the section of the Smith Guidance dealing with communications with shareholders to include a requirement for the provision of information relevant to the auditor re-selection decision. (A.2.4, pages 32-33)"
- recommendation 9 - "When explaining auditor selection decisions, Boards should disclose any contractual obligations to appoint certain types of audit firms. (A.2.5, pages 34-35)"
- recommendation 10 - "Investor groups, corporate representatives and the FRC should develop good practices for shareholder engagement on auditor appointment and re-appointments and should consider the option of having a shareholder vote on audit committee reports. (A.2.6, pages 36-37)"
- recommendation 12 - "The FRC should review the Independence section of the Smith Guidance to ensure that it is consistent with the relevant ethical standards for auditors. (A.3.2, pages 42-43)"

The review of the Code will need to consider stakeholder reaction to the MPG's interim recommendations before deciding on the most appropriate action for these recommendations.

In our view, further guidance and the emergence of best practice for audit committees is currently an area where additional guidance could make a substantial difference to investor understanding of the financial reporting process and the key areas of judgement in that reporting. Grant Thornton would be delighted to assist the FRC in generating guidance for audit committees if required.

If you have any questions on this response, please contact Steve Maslin (phone: 0870 991 2736; email Steve.Maslin@gtuk.com) or Nick Jeffrey (phone: 0870 991 2787; email Nick.Jeffrey@gtuk.com).

Yours sincerely

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APPENDIX - GRANT THORNTON'S RESPONSE TO SPECIFIC QUESTIONS RAISED IN THE REVIEW PAPER

Question 1: Does the Code support better board performance over time?

Grant Thornton view: Yes. We believe that the Code has had a positive impact on behaviour of UK boards, and on understanding of investors about how their investee companies are run. Indeed, it is a measure of the impact of the Code that comment from stakeholders looks at marginal issues, rather than promoting fundamental change.

Question 2: Is the "comply or explain" approach working effectively?

Grant Thornton view: Yes. The "comply or explain" approach is proven to have achieved significant change for the good. Grant Thornton's Corporate Governance Review shows that disclosure is generally good and continues to improve. The 2006 review found that of the two thirds of the FTSE 350 that do not claim full compliance with the Code, only 4% fail to provide any explanation as to why they are non-compliant. The vast majority on "non-compliant" companies actually explain the departure rather than just outlining the areas they are non-compliant with.

Question 3: What impact has the Code had on smaller companies?

Grant Thornton view: Generally smaller public companies implement the main principles of the Code. Most small companies now have significant input from independent directors whilst embracing the concept of a unitary board, and most smaller listed companies have a remuneration committee and an audit committee. These are tangible improvements in governance.

Appropriate use of the "comply or explain" concept generally ensures that the share price of these companies is not unduly penalised where they do not comply with the entire Code.

Our Review looks at disclosure in the FTSE 350. We found that the "mid 250" (FTSE 101-350) have continued to address the gap in application of the Code between them and the FTSE 100, who historically have provided better disclosure. Whilst the gap is now less significant, it has taken time to close, perhaps due to lower interest from investors in these companies or lower resource.

Smaller listed companies take advantage of the Code's flexibility in respect of board and committee composition. In our experience, particularly in respect of AIM and large private entities, companies tend to look to the principles of the Code while not necessarily attempting full compliance.

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

Grant Thornton view: Investors and companies alike have now had several years of experience of working with the Code. Rarely do companies make material changes to corporate governance statements from one year to the next, perhaps reflecting that suitable practices are now embedded within those organisations. Companies could more appropriately be required to maintain a corporate governance statement on their website, where that statement must be refreshed at least annually and each time there is significant change to the entity's corporate governance practices.

We have a concern that if the Code were to become more detailed than it is at present, then corporate governance statements would include more explanation of why certain provisions are not complied with. As a result, from one year to the next, the marginal benefit obtained by investors from corporate statements would fall. If the corporate governance statement were to become more detailed, the impact of significant disclosures such as those on business risk would become diluted in the eyes of the reader. On the whole this would be more unhelpful to investors than the marginal benefit sought from additional Code provisions.