



Chris Hodge
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20 July 2007

Dear Chris

Review of the Impact of the Combined Code

Independent Audit Limited provides consulting services to a wide range of boards and board committees in helping companies strengthen governance. Our work includes giving advice on board effectiveness and governance reporting. Our responses to the questions you raise in the consultation document are based on perceptions formed from working with clients and regular discussions with other companies and institutional investors.

Does the Code support better board performance over time?

Yes, the Code does support better performance where the board takes the time to understand the intent behind the Code Principles rather than simply focusing on compliance. Over the past two years we have seen both companies and investors develop a better understanding of the need to avoid a compliance-driven approach, but this seems to have grown more rapidly in larger companies than in smaller ones. The Code already clearly states the importance of the underlying Principles and the concept of “comply or explain” but there may be opportunities for the FRC to reiterate and emphasise how this should work, particularly for smaller companies.

The requirement for boards to review their effectiveness has improved the performance of those boards that have taken it seriously. A diminishing number of companies seem to be viewing it as a compliance formality and it is our impression that a significant proportion of boards are now conducting structured reviews and finding them useful. Although self-assessment remains the most common approach, there seems to be a trend toward involving external advisors on some sort of rotational basis. These are relatively subjective impressions but we are

currently engaged in a structured survey which should provide additional information.

In terms of review of committee effectiveness, our impression is that the picture is more mixed. Most companies appear to be wrapping up the committee reviews as part of the board review. This runs the risk of not adequately taking into account the particular issues relevant to the individual committees. Where reviews are done, they are sometimes restricted to assessing whether the committee's terms of reference have been fulfilled, rather than being taken as an opportunity for continuous improvement.

Most companies appear to be complying with the requirement to evaluate individual directors, but the quality and impact of this in improving director performance is extremely variable.

Reporting on evaluations is generally poor. We believe that board commitment to this process would be further strengthened by their being encouraged to report more expansively on the approach taken and on what actions are being taken to enhance board performance.

We would welcome greater emphasis being given in the Code to the importance of a thorough review of board committee effectiveness.

Is the “comply or explain” approach working effectively?

The approach is working better with a more listening attitude from many on the institutional investor side. However, many companies appear to be experiencing continued frustration with certain institutions, agencies or commentators. Smaller companies, in particular, have little confidence that their explanations will be listened to. We believe that there is work for the FRC to do in encouraging more informed shareholder engagement, without which the comply or explain approach will not achieve its full potential.

However, it is fair to say that companies could often do more to provide better explanations. If they were to abandon boilerplate in favour of clear communication of their approach to governance and the way their board operates, institutions would have less excuse for not helping to make comply or explain work. Clearer guidance on and examples of good governance reporting would be helpful.

What impact has the Code had on smaller companies?

The Code appears to have had a positive impact, bringing governance onto the agenda at companies which otherwise may not give it sufficient attention. We have the impression that the picture is mixed: many are pragmatic in applying the Code, and recognise the flexibility the Code gives to small companies, while others lack the confidence or the interest to go beyond a compliance-based approach. This may be because they have particularly low expectations of the willingness of

investment institutions and agencies to devote time and attention to their explanations.

It would be of benefit if the FRC were to provide guidance for smaller companies' boards and investors, highlighting the importance of understanding the Principles, applying them pragmatically and reporting more effectively on their governance.

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

Our surveys of governance reporting over the past three years have indicated a gradual but discernible improvement in governance reporting by FTSE 100 companies. Audit committee reporting has shown a marked improvement. Reporting on the board itself is patchy, particularly in relation to what the board has actually done during the year and how its membership meets its strategic development needs. Reporting on how remuneration and nomination committees meet their responsibilities remains particularly weak.

We do not believe that good governance reporting should involve any significant cost to companies and have little sympathy with cost as an excuse for failing to provide useful insight on their governance. The problem relates more to a lack of attention at board level, usually as a result of feeling that the content of the governance report is unimportant.

We believe that an emphasis on good reporting can help to drive the right behaviour: if boards concentrate on what they are communicating about governance, they are likely to think harder about the nature and benefits of their work as boards and governance activity in general. The FRC could usefully provide guidance in this area.

For more detail on our assessments of governance reporting, please refer to our 2006 survey (www.independentaudit.com/ourpublications).

For a comprehensive set of suggestions on how reporting could improve, please refer to our publication "Better Governance Reporting" (www.independentaudit.com/goodreporting/governance).

Yours sincerely



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