



Institute of Directors

REVIEW OF THE IMPACT OF THE COMBINED CODE

JULY 2007

This paper gives the Institute of Directors' comments on the Financial Reporting Council's *Review of the Impact of the Combined Code* issued in April 2007.

For further information please contact:

Patricia Peter
Head of Corporate Governance and Employment
Institute of Directors
116 Pall Mall
London SW1Y 5ED

Tel: (020) 7451 3113
Fax: (020) 7839 2337
E-mail: patricia.peter@iod.com

Review of the Impact of the Combined Code

The Institute of Directors welcomes the opportunity to comment on the Review of the Impact of the Combined Code

The Institute of Directors

Founded in 1903, the Institute of Directors (IoD) is an independent non-party political organisation of individual members and now has some 52,000 individual members. The membership is drawn from across all sectors. 86% of FTSE 100 companies and 70% of FTSE 350 companies have IoD members on their boards, but the majority of members (about 70%) are directors of small and medium-sized enterprises, ranging from long-established businesses to start-up companies. The organisations from which our members are drawn employ over 10 million people in the UK, i.e. over 40% of the workforce.

The IoD's aim is to serve, support, represent and set standards for directors to enable them to fulfil their leadership responsibilities in creating wealth for the benefit of business and society as a whole.

Introductory Comments

- The IoD welcomes the Code being kept under regular review. It needs to be relevant to the needs of both companies and investors and provide a clear demonstration of what is regarded as good practice from time to time. This is particularly important for those companies, probably the majority, who want to adopt and apply good practice, but are not at the forefront of the development of such practice.
- The Code should not be allowed to become too far ahead of the normal, well-run company. It should reflect good practice, not be an aspirational document, or a home for experimental governance practices to which either very few aspire, or which may be a quirk of governance fashion.
- We very much welcome the commitment to make changes to Code only where there is clear justification.
- We consider that much of the success of the Code, particularly for smaller companies, depends on investor attitude to comply or explain. We consider that investors should be open in stating how much (or how little) resource they devote to the governance of companies apart from a box ticking exercise. This is equally true for advisory and proxy agencies.

Answers to the questions asked in the review

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

The IoD as an organisation recognises that corporate success has to be based on an appropriate blend of enterprise, entrepreneurial drive, strong

strategic frameworks and controls, in other words governance. We are strongly committed to improving board performance in all organisations, indeed this is at the very heart of our philosophy, which includes:

“Helping you develop your ideas in a manageable way

As a director, you’re likely to be entrepreneurial, but your good ideas need to sit within a framework of plans and controls as well as market knowledge.”

Promoting professionalism in the boardroom

Directors realise that high standards of excellence and professionalism in the boardroom are essential for business success. The IoD has been supporting directors in their professional development for many years.”

These are closely aligned to the purposes of the Code, and have provided the basis over the years for the IoD’s work in director development. The IoD is committed to increasing the effectiveness of individual directors and boards, recognising that it is only through effective individuals and boards that companies can fulfil their potential and deliver shareholder value. The Code has helped to provide a basis for the growing recognition of the need for a professional and systematic approach to performance and governance, and if correctly applied by companies and interpreted by investors the Code provides an appropriate balance between the corporate performance and compliance aspects of the directors’ role.

While there are companies that are able to develop their own governance practices to help achieve this success, the vast majority either do not have the resources or are not sufficiently committed to do this on their own. Those who do develop their own practices are those from whose best practices generally accepted good practices develop.

We believe that there is a growing recognition of the need for an appropriate balance to be struck between performance and compliance, although there are inevitably those who find a simple box-ticking approach more convenient than a more considered one, and this can apply to both companies and investors. In the early days of the Code many boards were grappling with concepts that were new to them. This inevitably led to an over-concentration on the letter of the Code rather than the purpose behind it. As both companies and investors have become more familiar with the Code these problems are reducing, but it is important that complacency does not creep in; a level of tension is beneficial.

Many directors, particularly those not in an executive capacity in the company, do indicate that they consider that a disproportionate amount of their effort is directed towards compliance and conformance, rather than the strategic direction of the company. We believe that if this is a real concern within companies it is something that needs to be addressed both by investors in their interface with companies and to some extent internally within the company which may have issues that are more concerned with the effectiveness of the Chairman or development needs among directors.

In summary, the IoD believes that the Code has contributed to board performance, as it sets out in clear and simple terms matters that boards and individual directors should have regard to. We believe that the Code can have the effect of assisting cohesiveness by aiding recognition of the sometimes different challenges facing directors depending on their position in relation to the company, but careful thought has to be given to the approach and language of the Code if it is not to undermine the unitary board.

2. *Is the 'comply or explain' approach working effectively?*

The IoD wishes to state that it is a strong supporter of the non-prescriptive approach taken by the Code, and believes that this approach has been one of the reasons for the UK's consistently high ratings in comparative governance rankings. It is an approach which, however imperfectly applied, encourages a thinking approach to governance. Governance is not a precise science and a prescriptive approach is inappropriate.

In an ideal world the terminology would be changed from 'comply or explain', as this does have somewhat prescriptive connotations, but this is now in such common usage not just in the UK that it is probably impossible to change without giving an impression of lowering of standards.

In its response to the 2005 review of the Code we said "Implementing a 'comply or explain' approach to governance requires real thought and considered behaviour on both sides. Companies will be disinclined to give meaningful explanations that can require them to disclose sometimes personally sensitive information if they believe that such explanations will be widely ignored and a box ticked on the basis of 'non-compliance'."

While in theory it would be possible for all companies to develop and disseminate their own ways of practising and demonstrating their application of the drivers of good governance, this would in practice be impractical. The majority of companies have neither the resources nor the inclination to develop their own approaches to governance and rely on guidance and assistance from others. The IoD is among the sources of such advice and assistance. We recognise, however, that a common approach is of value, and the Code is an appropriate way of achieving this.

The other aspect of the equation is the requirements of the investment community. While a box-ticking, one-size-fits-all approach has to be condemned, there is a need for a common and accessible approach that facilitates provision of information by companies and analysis by investors who have to address the governance of a large numbers of companies and make decisions in response to the information they receive.

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

The positive effects of the Code are that it has increased awareness of governance issues among smaller companies and it provides a useful framework on which they can build their governance practices. These are the companies that on the whole would not be at the forefront of governance developments, often because of resource constraints. To that extent the Code has had a significant impact on smaller companies; in terms of real impact on their governance practices probably greater than on many larger companies. To this extent the Code must be regarded as a success, and this aspect should be highlighted in relation to smaller companies.

Against this general beneficial impact, smaller companies often had the most changes to make in order to be able to satisfy investors about their governance practices, and fewer resources either to implement the Code or provide good quality explanations. Investors in turn generally devote few resources to the evaluation of explanations in the case of smaller companies. These factors combine to make the perception of the Code within smaller companies less positive than it probably should be.

It is not the letter of the Code, but its overall philosophy and influence that have been important.

With regard to specific modifications for smaller companies, we have in the past stated that there should be a period over which new entrants to the market should be permitted to be 'non-compliant' without the need to offer any explanations. Beyond this, we are not in favour of a two-tier Code, but would urge investors either to take a more proportionate and considered approach to application of the Code by smaller companies or, if they are prepared openly to acknowledge that they are not going to devote many resources to evaluation of governance reports in their voting recommendations for smaller companies, simply state that they have not (or not fully) evaluated the company's approach to the Code.

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

Regarding the cost to companies, any resources devoted to disclosure itself are only worthwhile if they are useful to those recipients to whom they are addressed. This is not to say that the exercise of reviewing governance against a framework such as the Code for internal purposes is not worthwhile. Indeed, an analogy might be the now defunct OFR, where many companies, particularly indeed smaller companies, found that the discipline of the framework was a useful tool for the board.

The IoD is not able to comment objectively on the usefulness of the information to shareholders. It is for them to determine to what extent they find reported information useful as a real demonstration of governance

practice within a company.

Other comments

As mentioned in answer to question 2 in the consultation, the IoD considers that it is important that the Code does not have the effect of undermining the unitary board. In our submission on the *review of the role and effectiveness of non-executive directors*¹ we commented on the basic premise of the review: i.e. the growing practice of drawing lines between members of unitary boards who have the same legal responsibilities and accountabilities. We believe that the concentration on 'non-executive' directors and the consequent language of the Code has made an unwitting contribution to some of the issues that are being raised in the current review, particularly perceptions of a breakdown in board cohesiveness. Any re-drafting of the Code should avoid the use of the terms 'non-executive' or 'executive' director as far as possible, in order to reinforce the unitary nature of the board and the need for those directors with executive posts within the company to show independence of thought when acting in their capacity of director rather than executive, and for those without executive roles to play a full part in the aspects of the board's work that are directed to achieving corporate success. All directors must recognise that they have responsibilities and obligations in all areas of the board's role and the structure and language of the Code should reinforce this.

2. Conclusions

The IoD believes that the Code has been and continues to be a significant element in the awareness of the need for effective directors and boards. This view is based more on the philosophy of the Code and the main principles than the letter of the Code provisions. It is the latter that can tend to encourage compliance or divisive mentalities on boards and a box-ticking approach among investors. Our particular concerns are that cohesiveness in the boardroom might be further eroded, with non-executive directors becoming overly focussed on compliance rather than testing strategy and performance, and those directors with executive responsibilities outside the boardroom not applying independence of thought in the boardroom.

It is not the letter of the Code, but its overall philosophy and influence that have been important and this approach must be maintained.

Institute of Directors

July 2007

¹ Institute of Directors "Review of the role and effectiveness of non-executive directors" and "Audit committees: Combined Code Guidance" Response to the Reviews 10th April 2003