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Dear Chris

Review of the Impact of the Combined Code

Introduction and Executive Summary

We have pleasure in submitting our comments on the above consultation. Our overall view is that the Code is working well and we welcome the commitment that changes will not be proposed without clear justification and separate consultation.

Our main proposals which are discussed more fully below are that:

- the preamble to the Code should emphasise its primary objective to promote entrepreneurship and effective risk management
- boards should be reminded of the value of thorough board evaluations in helping them achieve their full potential
- there should be a thorough review of the present approach requiring boards to state how they have applied the Code's principles as this is leading to much 'boilerplate' disclosure. A new overarching strategic statement on strategy, performance and board cohesiveness should be introduced
- a survey should be undertaken of the quality of corporate governance disclosure currently being provided on areas such as board evaluations, the work of the nominations and audit committees, how the board develops an understanding of major shareholders' views and explanations of departures from Code provisions
- a project should be initiated on the role of institutional shareholders in corporate governance having regard to the increasing role being played by some short-term investors in leading listed companies
- a review should be undertaken of the guidance on the role and work of the audit committee
- consideration should be given to whether the Code has a fuller role to play than hitherto in respect of large international listings in London.

Response to issues for comment

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

The Code does support better board performance over time and successfully promotes entrepreneurship and effective risk management. As the consultation paper highlights, an effective board requires that priority be given to strategy, performance and board cohesiveness.

We are conscious, however, that some directors still express concern that significant amounts of board time are spent on corporate governance issues that they view as being compliance-orientated. It may therefore be helpful to stress the overarching purpose of the Code in the preamble and to exhort boards to apply it with this goal to the fore.

In the above context, we would also support the preamble giving encouragement to boards to recognise the value that can be derived from an effective board evaluation that is forward-looking and which both seeks to build on strengths and identify areas for development. Board evaluations were one of the main innovations when the current Code was first introduced in substantially its present form in 2003. Whilst there generally has been growing acceptance of the benefits that can be gained from a thorough evaluation, there is still significant variation in the time and commitment devoted to evaluations by different boards and some would be able to enhance their effectiveness by reviewing their practice in this area. Even very successful boards will be able to develop further the leadership they provide to their businesses and indeed leading-edge boards are generally very committed to the use of evaluations. A number of boards disclose changes they are implementing following the evaluation, as well as how it was undertaken, and this can provide useful insights to shareholders and other readers of the annual report.

There may be merit in considering renaming the Code 'The Code on Board Effectiveness and Corporate Governance' to highlight its key objective as most of principles and provisions of the Code relate to the board's composition and how it functions.

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

We believe the 'comply or explain' approach is working effectively. Boards should have the confidence to explain a departure from a provision of the Code where they genuinely believe it is in the interests of their shareholders - the owners of the business - that they do so. They should not feel obliged to comply with a provision that is not appropriate to the particular circumstances of their business merely to avoid any adverse comment. Equally, we would expect the number of departures from the Code's provisions to be relatively few though they are likely to occur a little more frequently in the case of smaller listed businesses. That said, even for smaller listed companies explanations rather than compliance should not be needed with regard to many provisions as the Code is based on good business practice. Moreover, companies outside the FTSE 350 are now only called on to have two independent directors - as opposed to a number equal to half the board's membership excluding the chairman in the case of larger listeds - thereby reducing the cost of full implementation for them.

It would be helpful for the FRC to review which provisions are most frequently giving rise to explanations and in respect of each one to ask whether or not this suggests that it should be revisited

for all or possibly just smaller listed companies. A review of the quality of disclosure when explanations are provided would also be useful.

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

As discussed above, so long as it is accepted that there may be some more instances of departures from the Code's provisions by smaller listed companies, we believe implementing the Code helps enhance the board and business performance of smaller listed companies as well as their larger counterparts. Given that the range of businesses contained within a smaller listed company is generally less broad and the group structure less complex, it will normally be possible to implement the Code in a more straightforward manner.

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

We believe the area of disclosures called for in the Combined Code would benefit from a thorough review.

The present requirement, under the Listing Rules, to disclose how the principles, both the main principles and the supporting principles, have been applied leads to significant amounts of 'boilerplate' disclosure. More importantly, companies are not currently asked to provide information on some key aspects of board effectiveness.

The boilerplate disclosure arises to some extent from an overlap between the principles and the provisions with it being obvious how companies have implemented the principles in some areas from the fact that they have not explained any departures from the related provisions. In others, the supporting principles set out in reasonable detail what action the board should take in order to apply them and so there will be an inherent tendency to include similar wording in the annual report.

The principles should call on the board to provide an overarching statement on strategy, performance and board cohesiveness, covering:

- the group's vision and strategy
- the board's role in setting the strategy, ensuring its alignment with the organisation's capabilities and in keeping it under review
- how the key performance targets have been derived from the strategy and how performance is monitored by the board
- how the remuneration policy for the executive team is closely aligned with the group's strategy
- how the board ensures it achieves its full potential, eg. how it approaches board evaluations, and how it is making sure the right board is in place to meet current and future needs
- the principal risks, how they are linked to the strategy and the board's role in managing them effectively
- how the board promotes effective two-way communications with its major shareholders

Some but not all of the above issues are required to be discussed by the current principles and, in some instances provisions, but the principles also address some less fundamental issues.

A move to focus on a more strategic statement by the board, of the kind proposed above, on how it is fulfilling its role, in place of the current detailed disclosures relating to the application of the main and supporting principles, would provide a much better insight into board effectiveness. It would also emphasise the Code's role in providing a framework for boards to maximise value creation in the business and to protect it effectively.

The suggested new approach to disclosure may lead to some of the supporting principles becoming provisions, with appropriate adaptation, so that there was helpful discussion when they were not considered applicable to a particular business. In addition, some of the current provisions may end up being dealt with as part of the board's statement on strategy, performance and cohesiveness.

As part of the disclosure review, it would be helpful for FRC to undertake a survey of the quality of disclosure by listed companies under the current Code. This should focus particularly on new disclosures included for the first time in the Code in 2003. The survey would therefore cover areas such as board evaluations, the work of the nomination and audit committees and how the board has developed an understanding of the views of major shareholders about the company. As discussed in the response to question 2, the survey should also review explanations provided when there has been a departure from a particular provision of the Code.

We have also made suggestions for some additional disclosures by the audit committee in our response to the interim report of the Market Participants Group, "Choice in the UK Audit Market".

Other important issues

Review of likely long-term effectiveness of the Code

It would be timely for the FRC to initiate a project on the potential impact of changes in the pattern of share ownership on the long-term effectiveness of the Code's 'comply or explain' approach which we strongly support. This approach relies to a significant extent on the influence that long-term institutional investors have in listed companies at a time when in certain circumstances short-term investors are having a critical role in determining their future ownership. The suggested project should be wide-ranging in scope and look, for example, at the extent of challenges faced by companies in knowing at certain times who will vote their shares. It would also consider whether Section 2 of the Combined Code on Institutional Shareholders needed to be developed further and perhaps dealt with in a separate document. The view has existed for a number of years that further work needs to be undertaken on the role of institutional shareholders in corporate governance and we believe this need has increased significantly in recent times.

Review of guidance on audit committees

The review of the Combined Code should review the current guidance on audit committees. In doing so, it should consider

- whether the Smith guidance on audit committees should more formally be brought within the scope of the Combined Code (the same issue arises in respect of the Turnbull guidance on internal control)
- the need for further guidance on the evaluation of the external audit process
- the need for guidance on putting the audit out to tender at regular intervals and on the selection process
- the committee's role in relation to dialogue with shareholders on audit-related issues.

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Applicability of Code to large international listings in London

At present the Code is applicable to UK-incorporated companies listed on the London Stock Exchange. We would also see merit in the FRC exploring, perhaps with others, whether the Code has a more extensive role to play than in the past in relation to large international listings in London on the main market and AIM especially where the company does not have its primary listing on another leading capital market.

If you would like to discuss any matter in our response please do not hesitate to contact Anthony Carey on 020 7220 3282.

Yours faithfully

Mazars LLP