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Revisions to the UK Corporate Governance Code, Guidance on Audit Committees and UK Stewardship Code

Dear Chris,

Thank you for giving the Institute of Directors (IoD) the opportunity to comment on your consultative document, published in April 2012. Issues surrounding corporate governance are of considerable interest to the IoD and its membership. We are therefore pleased to present our views in respect of your consultation on revisions to the UK Corporate Governance Code and guidance on audit committees.

About the IoD

Founded in 1903, and granted a Royal charter in 1906, the IoD is an independent, non-party political organisation of around 40,000 individual members. Its 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. The membership is drawn from right across the business spectrum. 92% of FTSE 100 companies have IoD members on their boards, but the majority of members, some 70%, comprise directors of small and medium-sized enterprises, ranging from long-established businesses to start-up companies.

Comments on main proposed changes

1. Addition to the Preface of the Code, section 8

The FRC proposes to add a new section to the Preface stating that “While the main focus of the Chairman’s statement is towards holders of equity capital, chairmen are also encouraged to use the opportunity to recognise the contribution made by debt investors in providing capital and to confirm the board’s interest in listening to the concerns of bond investors insofar as these are relevant to the company’s overall approach to governance.”

At first sight, this appears to be a reasonable addition to the Code. However, the addition of a new section recognising the governance role of bondholders gives rise to the question of why other company stakeholders – such as employees, suppliers, customers, banks, local communities, regulators, the media, etc – are not equally recognised within the Code. Should not chairmen also listen to their input in respect of the company’s governance approach?

Shareholders continue to enjoy a privileged governance position in UK corporate governance and UK company law (notwithstanding the changes made to directors’ duties in the Companies Act 2006). In contrast to other European countries, the UK has not historically adopted a stakeholder approach to

corporate governance, i.e. in which shareholders are just one amongst a much larger group of governance actors.

If more of a stakeholder orientation is to be introduced into the Code, there is no compelling reason why bondholders should be specifically highlighted. All relevant stakeholders would have a case for strengthening their position within the Code, which would fundamentally alter its nature. In the absence of a major public debate on the shareholder/stakeholder orientation of UK corporate governance, we are not sure that the UK corporate sector is ready for such a change.

In order to avoid this problem, we would prefer the Code to retain its current focus on shareholders. The Code primarily exists to promote engagement between boards and shareholders. We do not think that this clear objective should be complicated by widening the focus of the Code to other stakeholders, including bond holders.

2. Addition to introductory section on 'comply or explain'

The FRC proposes to add a new section in order to illuminate the nature of a meaningful explanation:

“In providing an explanation, the company should aim to illustrate how its actual practices are consistent with the principle to which the particular provision relates, and contribute to good governance and promote delivery of business objectives. It should set out the background, provide a clear rationale for the action it is taking, and describe any mitigating actions taken to address any additional risk and maintain conformity with the relevant principle. The explanation should indicate whether the deviation from the Code’s provisions is limited in time and, if so, when the company intends to return to conformity with the Code’s provisions.”

We support the idea of providing further clarification regarding the nature of a meaningful explanation. However, we find the middle sentence in the above wording (“it should describe any mitigating actions taken to address any additional risk”) to be unclear and potentially difficult to implement

A company may not consider that it is taking any additional risks through the adoption of its alternative solution. Consequently, it may find it difficult to determine what an appropriate mitigating action might be.

We prefer the following simplified sentence: “It should provide a clear rationale for the action and explain how it is maintaining conformity with the relevant principle.”

3. Addition to Provision B.2.4. on board diversity

The FRC intends to add the following wording:

“This section should include a description of the board’s policy on diversity, including gender, any measurable objectives that it has set for implementing the policy, and progress on achieving the objectives.”

This new wording is not the subject of the current consultation. However, we wish to indicate our support for this change.

It is also proposed to add the following to this provision, relating to appointment process for a chairman or a non-executive director:

“Where an external search consultancy has been used, it should be identified in the report and a statement should be made available of whether it has any other connection with the company.”

We support this addition.

4. Addition to Provision B.6.2 on board evaluation

The FRC plans to add the following wording to this Provision:

“The external facilitator should be identified in the annual report and a statement should be made available of whether an external facilitator has they have any other connection with the company.”

We support this change.

5. Addition of a new Provision, C.1.3. relating to the annual report

The FRC plans to add a new Provision to section C.1 on Financial and Business Reporting.

“The directors should set out in the annual report the basis on which they consider that: the report is fair, balanced and understandable; and provides the information necessary for users to assess the company’s performance, business model and strategy.”

We have sympathy with the thinking behind this new Provision. It is indeed appropriate for the audit committee to consider if the annual report is “fair, balanced and understandable”, as well as monitoring its integrity. However, we find the wording unclear. It is not obvious to us how a company would set out “the basis” on which these objectives are fulfilled.

We appreciate that a company could reasonably be asked to provide a report that “is” fair, balanced, understandable, and provides the necessary information for users to assess the company. But how would they set out “the basis”? Ultimately the issue of whether the report presents a fair, balanced and understandable overview of the company’s affairs is a subjective judgement, which may only be objectively verifiable in hindsight. We would appreciate further clarification.

We are doubtful whether this Provision will have much practical impact on the quality of the annual report. Few directors would admit that their existing reporting is unfair, unbalanced or difficult to understand. Without objective standards, this addition to the Code could give rise to further boiler-plate and formulaic disclosures – as companies seek to demonstrate “the basis” for their judgements - with little improvement in investor understanding.

6. Addition of new wording in Provision C.3.2 on the role and responsibilities of audit committees

The FRC plans to add the following new responsibility for audit committees:

“to advise the board on whether the annual report is fair, balanced and understandable and provides the information necessary for users to assess the company’s performance, business model and strategy”

We support this addition. However, we are doubtful as to whether this proposal will have a significant impact on the quality of the annual report. The board already has full oversight responsibility for the report. However, it is marginally useful to clarify the contribution of the audit committee in this respect.

7. Addition of new wording in Provision C.3.6. on the appointment of the external auditor

The FRC plans to add the following wording:

“FTSE 350 companies should put the external audit contract out to tender at least every ten years.”

We support this new recommendation. We also think that the transitional arrangements proposed by the FRC are reasonable.

8. Addition of new wording in Provision C.3.7. regarding audit committee disclosures

The FRC plans to add the following wording:

“A separate section of the annual report should describe the work of the committee in discharging its responsibilities. The report should include: the significant issues that it considered in relation to the financial statements, and how these issues were addressed; an assessment of the effectiveness of the external auditor and the approach taken to the appointment or reappointment of the external auditor, including the length of tenure of the current audit firm and when a tender was last conducted; and, if the auditor provides non-audit services, an explanation of how auditor objectivity and independence is safeguarded.”

We are not clear about how the company will disclose its assessment of the effectiveness of the external auditor. Furthermore, we are not convinced that it is appropriate for the company to make a public disclosure regarding this issue. Ultimately, the external auditor has to behave in an independent manner. If the external auditor is inhibited due to the potential threat of being described as “ineffective” by the company, this could impact upon the external auditor’s independence.

We would prefer a more neutral wording, such as “a description of the functioning of the external audit process”.

We support the other changes.

9. Addition of new wording in Provision D.2.1 regarding remuneration consultants

The FRC plans to add wording to this Provision:

“Where remuneration consultants are appointed, they should be identified in the report and a statement should be made available of whether they have any other connection with the company.”

We support this change.

Revisions to the UK Stewardship Code

The FRC is also proposing a range of drafting and substantive changes to the UK Stewardship Code. These changes seek to:

- clarify the aim and definition of stewardship;
- delineate more clearly the varying responsibilities of different types of institutional investors, including making a useful distinction between asset managers and asset owners;
- address some new and previously highlighted issues relating to the nature of stewardship. This includes adding new guidance relating to stock lending, conflicts of interest policies, collective engagement, insider information and the role of proxy voting services;
- edit the previous text where needed to create greater consistency across the Code; and provide more information, where needed, on how the Code is expected to be implemented.

We are broadly supportive of the changes that are being proposed. Although the Stewardship Code is a work in progress, we agree that the changes improve the structure and clarity of the Code. However, whether they will exert a significant impact on investor behaviour remains uncertain.

Thank you once again for inviting the Institute of Directors to participate in this consultation. We hope you find our comments useful.

Yours sincerely,

A handwritten signature in black ink that reads "R. Barker". The signature is written in a cursive style and is underlined with a single horizontal line.

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