tomorrow's
company

Chris Hodge
Corporate Governance Unit
Financial Reporting Council

Dear Chris

2009 Review of the Combined Code
Submission by Peter Davidson, formerly Senior Innovation Advisor, BERR / DIUS and Tomorrow's Company

At our last meeting on 2 July, we discussed the preliminary recommendations from the study we have been doing on Innovation, Risk and Governance. At that time you asked that we consider in more detail current board evaluation practices and how these could practically be enhanced to improve board evaluation and performance.

We have therefore taken the opportunity to bring together a number of practitioners in this field, and through two workshops have developed a set of recommendations for your consideration. These follow on pages 2 to 4.

Additionally, we have now refined the earlier and broader recommendations from the study and these are provided in Appendix One.

Inevitably, there was some overlap from the workshop discussions and the main findings from the study. The outputs from the workshops have been presented separately but those of direct relevance to the subject of this report have therefore also been embedded in the main recommendations of the overall report.

The final report from our study is due to be published on 20 October, and we would be delighted if you could attend the launch event on that day:

13.30 – 15.30
Institute of Chartered Accountants of England & Wales
Chartered Accountants Hall, Moorgate Place, London, EC2R

We would be more than happy to discuss the recommendations in more detail with you if you wish.

Peter Davidson

Tony Manwaring

Peter Davidson
Senior Innovation Advisor BERR/DIUS 2007- 2009

Tony Manwaring
CEO, Tomorrow's Company

Recommendations from the workshops on board evaluation and performance.

The attendees were:

Kit Bingham – Odgers Berndtson
Pat Cleverly – Tomorrow's Company
Peter Davidson – BIS (Chair)
Bob Garratt – Chairman and Writer
Mark Goyder – Tomorrow's Company
Tony Manwaring – Tomorrow's Company
David Matthews – KPMG
Stuart Tunstall – Lucid Associates
Liz Walmsley – Praesta Partners LLP

Kindly hosted by David Styles – BIS.

In the short-term

1. Amendments to the Combined Code

a. Clarify the obligations and contracts of all Board Members

- Strengthen the preamble to the Combined Code to make the primary duties of a director clearer. Under company law, the primary loyalty of the director is to the company and all directors have a duty to exercise independent judgement. This applies without exception to all directors.
- Strengthen the Code guidance to recommend that executive directors have an employment contract that is distinct from the service contract that they sign as director. This is to reinforce their understanding that as board members they have a role quite distinct to that as an executive.
- Strengthen the Code guidance to emphasise the importance of director induction and continuing professional development for executive directors as well as their non-executive colleagues. Define a model induction programme to be included as an appendix to the Code and recommend disclosure of the steps taken with respect to induction and professional development including an indication of the amount of time spent by each director.

b. Independence criteria

The independence criteria, as applied, have become unhelpful at times to obtaining appropriate experience and judgment on boards. It would be useful to stress that individuals with key industry experience or other special qualities such as technology insight, even if they do not meet independence criteria because of past association with competitors, customers or shareholdings, can make a real contribution as NEDs. For both Executive Directors and NEDs, raising their general confidence to challenge independently around the board room table requires developing their 'intelligent naivety'. It is also essential that the Chairman's role be developed to encourage the right environment for constructive challenge to take place.

c. Extend the best practice guidelines in the area of board evaluation

In this context it is recommended that the current 'Suggestions of good practice' from the Higgs' Report be thoroughly enhanced and more closely aligned with the relevant Code recommendation. The good practice guidance should be non-mandatory, but should encourage:

- Annual evaluation of board performance (as currently recommended by the Code).
- Regular and periodic evaluation by an external organisation – in normal circumstances at least every other year.
- Boards to ensure that the external organisation providing the evaluation is not, in their judgement, conflicted by the other roles that it may have.
- The review should among other things cover:
  - the effectiveness of and the time given to the induction of directors
  - learning and development activity undertaken by the board
  - feedback mechanisms to get input to the review from below board level and from stakeholders outside the organisations.
- The reporting of board evaluation should also specify:
  - who conducted the evaluation
  - what other services that organisation supplied to the company
  - how it was conducted
  - what it concluded
  - what would the company be doing differently as a result.

d. Professional development

Stress that professional development applies as much to executive directors as it does to non-executive directors.

e. Nomination of Directors

Strengthen the Code Guidance to suggest that a regular review be carried out on the board skills needed to address the major challenges faced by the company, with an identification of major gaps and how and when they need to be filled. Take steps to improve the current disclosure re the biographical details of directors such that they explain why the director is on the board and how their knowledge skills and experience fit in with the company's strategy and objectives. Good disclosure could be monitored and tied into the award scheme referred to below.

2. Enhance the Turnbull/Flint recommendations on risk.

There is a concern that the corporate reaction to these has become too formulaic and that the recommendations could benefit from the addition of some practical best practice guidance with particular regard to management of 'business not as usual' risks.

In the longer- term

1. Create an award scheme

An award scheme should be established to celebrate best practice in the reporting not simply of the evaluation process but the action and change that had resulted from the identification of the issues is also suggested.

2. That the FRC convene an appropriate group (along similar lines to the Turnbull/ Smith Committees) to codify best practice for boards.

The group felt that there was room for improvement in terms of:

- better transparency to shareholders in the effectiveness with which the 'Tone from the top' or 'Felt leadership' exists for key areas within the company e.g. on risk management for financial services, ethics for accountancy or safety for transport and the process industries;
- allowing appropriate (but not indiscriminate) challenge;
- understanding the suitability of the Executive team 'risk management process' and (in the longer term) the appreciation of 'uncertainty' by the board.

These are areas that have sometimes been dismissed as too qualitative to measure but the experience of companies like DuPont in measuring 'felt leadership', in safety and correlating these to safety performance is instructive and could potentially be extended over time to measuring 'felt leadership' in risk management.

The FRC could consider asking BIS to sponsor work on quantitative measurement of 'felt leadership' in risk management.

3. The development of a toolkit for Boards.

This is needed to underpin best practice and would consist of performance review tools, techniques, processes and best practices coupled with a database of all board performance review reports. This could reinforced both by an award scheme on reporting and by improvements in the Continuing Professional Development (CPD) of directors.

4. Enhancing the effectiveness of directors

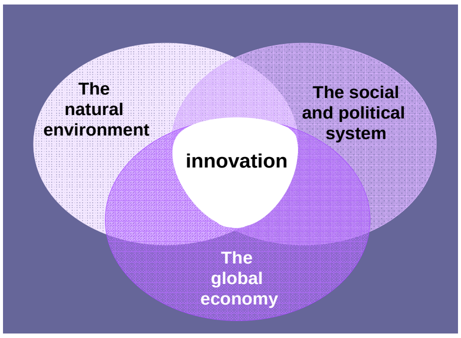
The group acknowledges the current Chartered Director qualification. However, it was felt that some of the most qualified directors would not consider seeking this and some of those with this status might not make the strongest director candidates.

It is felt that professionalism was best enhanced by a combination of the following:

- Developing in all candidates for director status the capability for 'intelligent naivety'.
- Strengthen especially the climate of challenge, ultimately to the point where executive board members might constructively challenge their CEO's viewpoint in board discussion.
- While respecting all existing forms of continuous professional development for directors, those who provided it could usefully learn from the experience of the recent crisis about the limitations of current director ability to deal with risk and uncertainty, and influencing those involved in professional development to extend their programmes to reflect this learning.

Appendix One
Executive Summary from the report
'Tomorrow's Innovation, Risk and Governance'.

Companies lie at the heart of humanity's ability to address many of the world's problems. As well as generating wealth and jobs, the innovations they make can have a major impact on environmental and social problems.

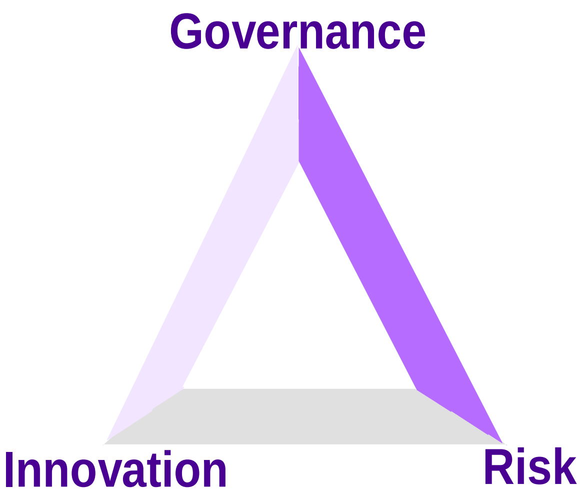


A helpful model of the context in which companies now operate is the' triple context' where future success is inextricably linked with the health of three interdependent global systems – the global economy, the natural environment and the social and political system. This 'connectivity' of the world leads to a business environment in which innovation and good risk management are at a premium as businesses seek routes to survival and businesses become a major route through which society can survive the many challenges facing us as a society.

The early 21st century is the 'time for innovation' — the pace is changing and companies are experiencing greater turbulence and larger shock waves than ever before. The complex world of diverse challenges, opportunities, need and expectations requires new and diverse thinking and a step change in a company's ability to identify and manage risk — especially at board level.

If companies are to survive they need to accelerate their exploitation of new ideas. However innovation is a risky business and companies must decide when and where to innovate — but not to innovate carries certain risk. Businesses that differentiate themselves by good risk and innovation management are likely to be an increasing proportion of successful companies and an ever greater force in the economy.

This study explores the relationship between diversity in board composition, effective governance and attitude to risk and innovation. Accepting the breadth of diversity parameters that exist, for the purposes of this study we have focussed on a number of the criteria that have been identified by two of our interviewees as significant in terms of perspective and contribution: gender, age, cultural background, experience of industry, educational background, time on the board, experience of adversity.



Findings

Our overall findings have been categorised into four key areas listed below.

To shed further light of these findings, research was conducted among members of the Institute of Chartered Accountants in England and Wales (ICAEW).

The survey explored members' perceptions of issues around board composition, corporate culture and business understanding in respect of boards of UK listed and equivalent entities. The research was undertaken between 14 and 31 July 2009 among members who sit on boards and those who do not. In total, 1,716 members who work in accountancy firms, industry or commerce, public sector or charities as well as retired members who are Non-Executive Directors (NEDs) completed an online survey. The questionnaire was designed by KPMG, while the ICAEW facilitated the process of setting it up online, distribution to its members and reporting of the results. Further detail is provided in Appendix Two.

Board diversity — the effect the composition of the board has on innovation and performance.

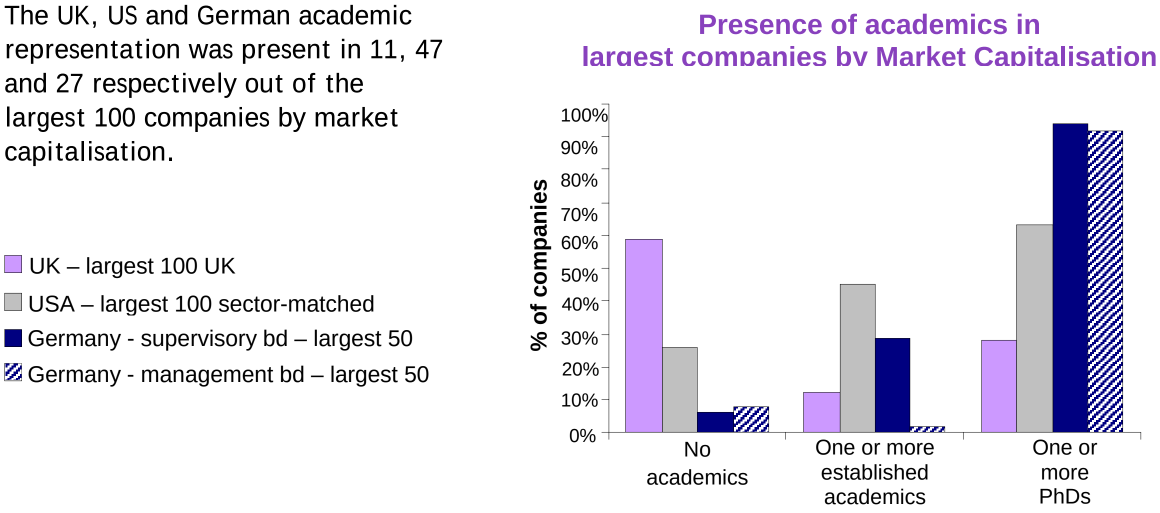
There is an issue with regard to board diversity in the UK compared to the US and Western Europe practice.

- US and UK boards differ in composition.
- Being one of a kind on a board inhibits input.
- Diversity in board membership helps reputation and legitimacy.

Over 80% of members of the ICAEW who completed the survey feel that Board diversity in its broadest sense is important in managing business risk and innovation.

The earlier work undertaken by the Royal Society looking at the academic representation on UK, US and German Boards is also presented in this report. This was undertaken as an indicator of difference in composition rather than reading too much other significance.[1]

The UK, US and German academic representation was present in 11, 47 and 27 respectively out of the largest 100 companies by market capitalisation.



[1] Unpublished research by the Royal Society commissioned by DIUS and BERR.

Effective dialogue — the role of dialogue and culture in stimulating innovation.

The prevailing culture of the organisation and within the board, along with the style of discussions within the board can impact on the innovative capability of companies.

- Being able to constructively challenge the Chairman & CEO's perspective is necessary for sustainable performance. Failure of boards to challenge executive directors was seen by nearly all ICAEW respondents as a contributing factor in the recent high profile governance breakdowns, and two thirds thought it was a major factor.
- Having strong organisational traditions and culture is fundamental to creating a conducive framework for innovation to flourish. Developing the culture and traditions which lead to superior performance can be helped by relevant stories and narratives.

Context — the impact of the operating environment on board diversity, innovation and risk management.

The external environment affects a company's ability to be innovative but is also an important source of innovation. In an increasingly global environment, the relevance of diversity in supporting innovation is not confined to within a company. Innovative companies that manage risk well build a supportive 'ecosystem' – within their sectors, the countries in which they operate, their supply chain, partners and other key stakeholders.

- The current regulatory environment can create a compliance mentality and lead to risk averseness and impacts on board composition.
- Being tuned in to the external landscape and the company's eco-system is essential to inform decisions on innovation and risk management.
- Board members from innovative companies seemed to be better networked.

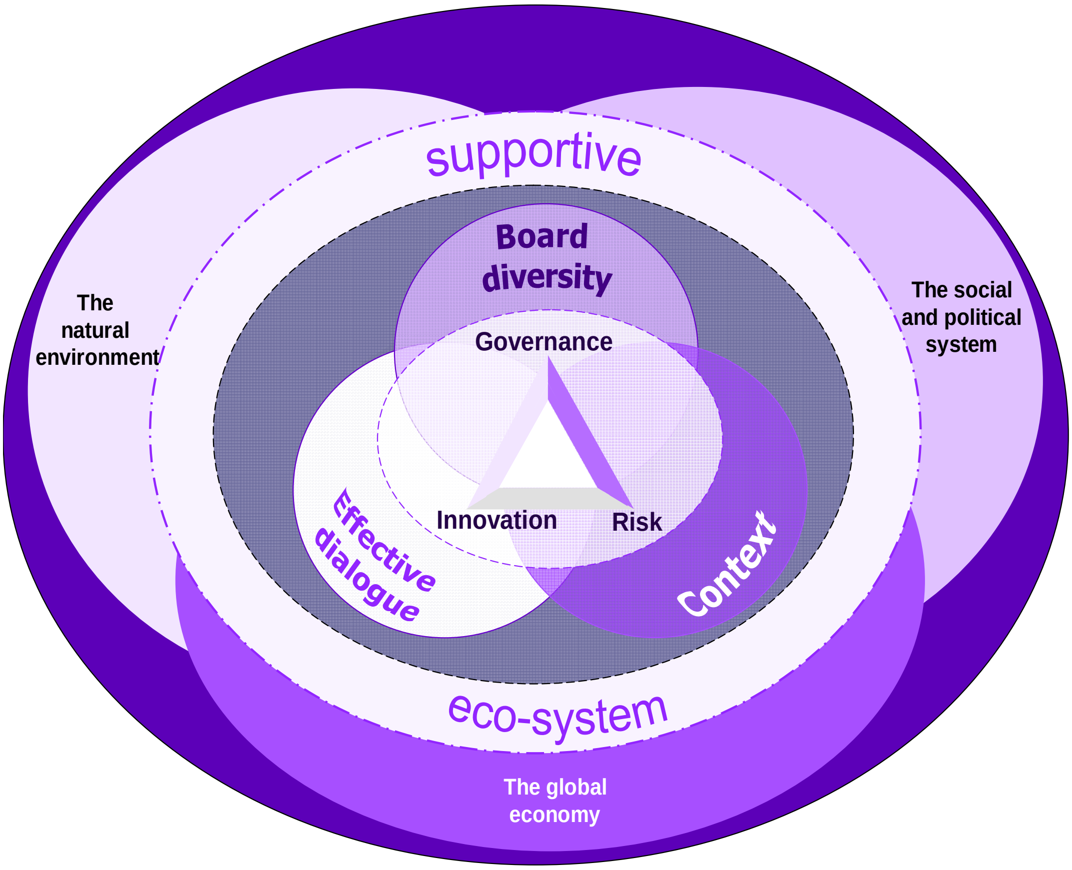
Managing risk and innovation.

Innovation - the successful exploitation of new ideas - involves risk. Risk comes in many forms and requires excellent information flows and insightful management by boards.

- Innovation requires support for risk taking and change, and tolerance of mistakes — yet the regulatory focus on risk and also the desire for short-term returns may lead to inappropriate risk aversion leading to greater risks.
- A board cannot assess or manage risk without good information which is timely, concise, relevant and as complete as possible, both from within the company and externally.
- There is a need for greater 'insightful independence' of thought around the board table – involving an understanding of the company and the environment in which it is operates — not just independence.

The ICAEW participants believe that risk management is too often inadequate or inappropriate: only a fifth of ICAEW respondents feel that boards have a strong understanding of ongoing operational risks. A large proportion (70%+) believe that boards have a poor or no understanding of business 'not as usual risks'.

The resultant framework that we have developed as a result of the work presented in this report is shown below.



Our recommendations

In considering our recommendations and the extent to which they may be considered as appropriate, it is perhaps helpful to turn the clock back some 150 years to when the first major legislation in the UK was passed on company reporting, the Joint Stock Companies Act 1844, requiring a 'full and fair balance sheet' to be presented. The furore created was such that the Limited Liability Act (1855) and the Joint Stock Companies Act (1856) withdrew the need for an audit and its publication. It was not until the Companies Act (1879) that the need for a 'full and fair balance sheet …to exhibit a true and correct view of the state of the company's affairs' *w*as reintroduced.

Few would argue that this has not been a positive development, and companies not only publish historic financial information but also forward looking information is presented. More recently, some companies have extended the information provided to include social and environmental impacts and again this is becoming more common place and recognised a good practice.

Demands for increasing transparency are likely to continue as investors and the public at large become ever more sophisticated in their assessment and views of companies and the vital role that they play in our society. The financial crisis and lack of transparency about the activities of some financial institutions has demonstrated only too vividly that that transparency is not a luxury but a necessity. Taking what are considered to be bold steps at a point in time requires foresight and courage but also creates an environment that encourages companies to be leaders in their field. In terms of governance, the UK has the opportunity to retain its leadership in this area and take further bold steps to help it do so.

Our recommendations focus on helping to encourage the good risk and innovation management essential to both company performance and the world in which companies operate.

During the consultation process for this study, two workshops were held looking specifically at current board evaluation practices and how these could practically be enhanced to improve board evaluation and performance with a particular emphasis on increasing transparency and feedback and measuring the important issue of 'tone from the top' as highlighted in this report. Inevitably, whilst the focus of the study is the relationship between governance, innovation and diversity, it was impossible to disentangle this particular aspect from wider matters relating to governance and board performance in the discussions.

Those outputs from the workshops which were of direct relevance to the subject of this report have been embedded in the main text and our recommendations. However, we are grateful to those who attended the workshops and for their input, drawing from their extensive experience in this field, and therefore felt it appropriate to present all the recommendations from these workshops to preserve the integrity of the ideas provided. (These have been provided on Pages 2 to 4).

We would encourage greater levels of transparency about how well the board works together and the codification of best practice.

Boards undertake significant reviews of financial performance and this information is also externally audited yet the same rigour is not applied in respect of the quality of the dialogue and 'tone from the top' with respect to innovation and risk management as well as overall board performance. We feel that there are areas for improvement in terms of:

- better transparency to shareholders in the effectiveness with which the 'tone from the top' or 'felt leadership' exists for key areas within the company e.g. on risk management for financial services, ethics for accountancy or safety for transport and the process industries. 'Felt leadership' is all about people. It is about creating an environment that thirsts for, and sponsors, continuous improvements and drives employee engagement that is characterized by a high level of individual ownership in the work place;
- encouraging appropriate (but not indiscriminate) challenge.

These are areas that have sometimes been dismissed as too qualitative to measure but the experience of companies like DuPont in measuring 'felt leadership', in safety and correlating these to safety performance is instructive and could potentially be extended over time to measuring 'felt leadership' in risk management. We would therefore encourage:

- boards to consider the use of the various tools and methods available that enable them to explore these aspects in more depth. Over time, it is hoped that leading companies might instigate independent audits in this respect. A further step would be to publish the findings in their annual reports or asking the Senior Independent Director to comment on how suitable the 'tone from the top' is;
- the Financial Reporting Council (FRC) to convene an appropriate group (along similar lines to the work of the Smith Committee) to codify best practice for boards, and to consider asking BIS to commission work to review quantitative approaches to measuring 'felt leadership' in risk management.

Boards should undertake regular reviews to ensure that the quality of information they are receiving both internally and externally stays relevant to changes in the company's operating environment.

In part this will come from the quality of input from NEDs. Therefore their selection and access to all parts of the organisation is key, particularly by ensuring that informal as well as formal avenues are made available and utilised. For example, encouraging NED's to spend time with employees unaccompanied by executives and inviting outside experts and commentators to present to the board on a regular basis. Additionally, it might be worth considering how well networked board members are, by comparison with their peers in other companies. Such information is available via information databases such as that provided by BoardEx.

To improve risk and innovation management - companies might undertake more systematic development of leadership, culture and learning processes. The Turnbull/Flint recommendations on risk should be reviewed.

Good risk management has been pioneered by the railway, airline and process industries, where the failure to manage risk results in the direct loss of life rather than only the loss of now very large sums of money now impacting the majority of the world's population. There is little transparency in risk management process and culture in many industries. It is clear that relying on independent NEDS (in the UK) or placing draconian rules on executive teams, such as Sarbanes-Oxley (in the US), has failed to protect sufficiently against unwise innovation in the financial services industry. There is also a concern that the corporate reaction to the Turnbull/Flint recommendations on risk has become too formulaic and the opportunity should be taken to review these.

Undertake a regular review of board skills against the evolving needs of the organisation and improve disclosure.

Many of our approaches to managing risks have been formed in an environment of 'business as usual'. Some companies have entered a period of 'business not as usual' where the operating environment has become uncertain and requires different competencies.

To ensure that the diversity of skills and thinking are available to address the major challenges faced by the company, we suggest that the existing guidance in the Combined Code is strengthened to recommend that boards:

- undertake a regular review on the board skills needed with an identification of major gaps and how and when they need to be filled;
- take steps to improve the current disclosure of the biographical details of directors so that they explain why the director is on the board and how their knowledge skills and experience fit in with the company's strategy and objectives.

We would urge standard setters and policy makers to consider revisiting the independence criteria established for NEDs.

An important role for the NED is to bring to the board a different and more externally facing perspective and to be a 'critical friend'. As the Higgs' report states: *"To be effective, non-executive directors need to be well-informed about the company and the external environment in which it operates, with a strong command of issues relevant to the business."*

The challenge of getting individuals with sufficient knowledge and experience of the company's operations who are also perceived to be independent is a difficult one. We believe that the independence criteria, as understood and applied, have become unhelpful at times to obtaining appropriate experience and judgment on boards and have become used as a proxy for qualities such as gravitas and weight of presence rather than real industry knowledge or the ability to translate learning from another industry or field into useful guidance for critical decisions. It is notable that technical understanding is better respected overseas in the Far East and the US than on the majority of UK Boards.

We also seem to have lost sight of the value that non-independent non-executives can bring. Independence of mind and judgement can be found in both in dependent and non-independent NEDs. It would be useful to stress that individuals with key industry experience or other special qualities such as technology insight, even if they do not meet independence criteria because of past association with competitors, customers or shareholdings, can make a real contribution as NEDs. For both Executive Directors and NEDs, raising their general confidence to challenge independently around the board room table requires developing their 'intelligent naivety'. This acknowledges that many directors reach a board with mainly specialist functional knowledge, but on becoming a statutory director they have to cope with all disciplines. To build their confidence, and thus fulfil their proper role as a director, they need to be encouraged to ask fundamental questions of the specialist and assess the consequent risks and opportunities. It is the Chairman's role to ensure they are protected in asking such questions as a key part of their induction to the board, especially for the first six months.

It is important that the regulatory framework currently being considered in the light of the financial crisis sets the right balance.

It is clear that the opening up of financial markets has brought very real benefits to the economies that have embraced them. Changes to legislation should be supportive to sustainable company growth and build on the development of the UK in general and London in particular based on the advantages of language, time-zone, talent, infrastructure and access.

Appendix Two

ICAEW membership views on board composition, culture and business understanding

Background

These are the findings for the research conducted for The Department for Business, Innovation and Skills (BIS) among members of the Institute of Chartered Accountants in England and Wales (ICAEW). The survey explored members' perceptions of issues around board composition, corporate culture and business understanding in respect of boards of UK listed and equivalent entities. The research was undertaken between 14 and 31 July 2009 among members who sit on boards and those who do not. In total, 1,716 members who work in accountancy firms, industry or commerce, public sector or charities as well as retired members who are Non-Executive Directors completed an online survey. The questionnaire was drafted by KPMG, while the ICAEW facilitated the process of setting it up online and sending it to its members.

Research headlines

1. Board diversity in its broadest sense seen as important

Board diversity in its broadest sense is perceived to be important by a large majority of respondents in respect of successfully managing business risk (81% very or fairly important) and encouraging innovation (81%).

Only around one quarter of participants believe that at present boards are generally sufficiently diverse when it comes to gender or cultural background, and approximately a third when it comes to age or academic expertise of its members.

These views are common to both those with more direct experience of boards – who work as either company directors and/or audit and risk committee members in either a FTSE or AIM listed or private company with more than 250 employees, and those with less direct experience.

2. There are rightly very high expectations of the quality of NEDS. The perception is that while some meet these high expectations this is not universal

There are very high expectations of what qualities should be possessed by Non-Executive Directors. More than 90% feel that all or most Non-Executive Directors within any particular board should demonstrate integrity and probity, sound business judgement, the ability to provide rigorous challenge, independence and to be trusted and respected by other board members.

However, against these high expectations there is a degree of mismatch in the extent to which all or most Non-Executive Directors are perceived to demonstrate these qualities at the present time. Just over half (55%) believe that all or most Non-Executive Directors do possess and demonstrate integrity and probity and a similar proportion (48%) think that all or most have the trust and respect of other board members, and a minority think that all or most have sound business judgement (39%) or particularly critically for boards, independence (36%) or the ability to rigorously challenge (22%).

It is significant to note that the gap between qualities that should be demonstrated versus those that are felt to be possessed is less pronounced when looking at the views of those who have more direct experience of boards. Over two thirds (69%) of them believe that all or most Non-Executive Directors do possess and demonstrate integrity and probity, and 61% think that all or most have the trust and respect of other board members. They are more divided in their views with regards to whether all or most possess sound business judgement (52%) and independence (48%). A minority of them (34%) believe that all or most Non-Executive Directors do possess and demonstrate the ability to provide rigorous challenge.

3. Lack of adequate information and briefings may contribute to Non-Executive Directors ability to constructively challenge their boards

Most of those surveyed (77%) perceive that Non-Executive Directors are not sufficiently challenging of their executive colleagues. This feeling, though to a significantly less extent, is also shared by those who have more direct experience of boards (62%).

While around half (52%) of all survey participants perceive that Non-Executive Directors have sufficient understanding of the business for which they are responsible to enable them to make a significant contribution to board decisions, the majority of those who have more direct experience of board (73%) believe that Non-Executive Directors have sufficient understanding.

Most of the survey participants think that Non-Executive Directors' ability to constructively challenge and contribute to board decision-making might be significantly inhibited by their access to the 'right' information (80%) and inadequate briefing by senior executives (80%).

Furthermore, only a minority of respondents believe that Non-Executive Directors attend sufficient external professional development briefings (27%) and internal briefings (24%) to enable them to get a better understanding of business in order to make an appropriate contribution.

Failure of boards to challenge executive directors is seen by nearly all respondents as a contributing factor to the recent high-profile governance breakdowns, and two out of three (68%) thought it was a major factor.

Again, there was no real difference in the views of those with more direct experience of boards with regards to any of these issues.

4. Risk management is too often inadequate or inappropriate

Nearly all held the view that inappropriate risk management is another factor which made a substantial contribution to recent governance breakdowns: nearly two thirds (65%) consider it a major factor.

Supporting the recommendations of the Walker Review, survey participants tend to believe that boards do not have a strong understanding of the risks facing the business: only one fifth (19%) feel that boards have a strong understanding of ongoing operational risks (though among those with more direct experience of boards this figure rises to 29%). The situation appears somewhat worse for 'business not as usual' risks, with a large proportion (70+%) believing that boards have poor or no understanding – regardless of level of direct experience of boards.

In line with the Walker recommendations, the majority (79%) think that companies should adopt different procedures and mechanisms to ensure that the management of both 'business as usual' and 'business not as usual' risks is fit for purpose. Furthermore, only one in three believe that companies' risk management and internal control systems are capable of reacting quickly enough to changing and unforeseen circumstances such as those we have recently witnessed.

5. There is support for the principle of periodic independent evaluations of boards

The current principle within the Combined Code is that a board should undertake a formal and rigorous evaluation of the board, its committees and individual directors. Survey participants are divided in their views on the recommendations of the Walker Review that this principle should be extended to require that these evaluations are undertaken by an independent party: overall over half of survey participants agree, compared with two fifths of those with more direct experience of boards (39%). Over half of survey respondents agree that these evaluations should be periodic (i.e. not every year).