INDEPENDENT AUDIT LIMITED

www.independentaudit.com
Holland House 4 Bury St.
London EC3A 5AW
T: +44 (0)20 7220 6580
F: +44 (0)20 7220 6581

Chris Hodge
Corporate Governance Unit
Financial Reporting Council
Fifth Floor
Aldwych House
71-91 Aldwych
London WC2B 4HN

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Dear Chris

REVIEW OF THE EFFECTIVENESS OF THE COMBINED CODE

Independent Audit Limited specialises in helping company boards assess the effectiveness of their governance frameworks and work out approaches to securing continuous improvement in their oversight activity. In our work with boards in companies across the FTSE 350 we see how the Combined Code is being applied in practice and where improvements in the Code and its application may be beneficial. We would like to contribute the following observations to the FRC's review.

General observations

- The Code has been highly beneficial in strengthening governance practice in the UK and elsewhere, albeit with a limit to what it can achieve. It would be unhelpful to turn it into a more detailed "manual" or set of standards. This would mainly lead to more box-ticking and lose one of its principal benefits – that it is a short guide to the principles which are needed to underpin sound governance. Companies need to think through what works best for them and be convinced of the benefits of their approach – not feel obliged to apply a prescribed formula, regardless of its actual usefulness.

- Application of the specific provisions of the Code should not become compulsory or seen as regulatory requirements. It is important to maintain "comply or explain". Any more demanding approach would very likely lead to changes in form but not improvements in substance.

- Having acknowledged the improvements that the Code has brought, it is important to recognise that governance practice continues to vary considerably. However, these differences cannot be tackled by regulation or more detailed guidance. With the Code having set out a clear basis for the practical foundations, effective governance to a large extent then comes down to behaviour in the boardroom and to relationships between directors and management. It depends on strong chairmanship and a clear awareness of the value of governance, the role of the board and the dynamics that influence good governance. And it requires the constant maintenance of a board culture which supports effective challenge. There may be areas where the Code can be revised and strengthened to provide more guidance in this respect (and we set out some suggestions below) but the scope for this is limited.

- The FRC may, however, have a stronger role to play in monitoring governance practice and promoting the development of best practice. This may involve periodic checks on board review approaches, a structured research programme, more detailed "best practice" guidance outside of the Code itself (eg through the publication of case studies) and more guidance on governance reporting. FRC resources might need to be bolstered accordingly.

Specific suggestions

1 Board composition

We question whether the provision (A3.2) that at least half the board be independent non-executive directors should be kept. This has often led to a reduction in the number of executive directors as boards have sought to avoid becoming too large while maintaining a minimum 50/50 ratio. Boards would benefit in numerous ways from more diverse executive director contribution (eg information flow, succession planning, quality of strategic debate) but primarily through a greater number of executives having director responsibilities and recognising the responsibility of the board and individual directors to the shareholders as owners of the business. In our experience, UK boards rarely put matters to a vote but instead seek consensus, which means that the effectiveness of the individual independent directors is much more important than their number.

2 The Board's role

Ultimately, board effectiveness is primarily driven by the Board (and each of its committees) having a clear and consistent view of its role. It needs to set out clearly and agree its objectives (in general and each year); determine how far its responsibilities extend and what the board is not responsible for or will not do; ensure that senior management fully understand its purpose; and discuss how it will work to achieve its objectives. It should also have a view on how it will assess the extent to which it has achieved these. If this is not clear, a board is unlikely to be fully effective.

The Code should put more emphasis on the importance of the board discussing, agreeing and defining its role and ensuring that this is understood and accepted by management – and agreeing with management how the board and the executive team will work together. Also, it should emphasise the need for the role to be explained to shareholders and for reporting by the board on its work during the year to be tied back to its role and specific objectives. This should not mean a simple recitation of reserved matters or terms of reference or application of boilerplate language: it should involve an insightful discussion of what the company's board sets out to achieve.

3 Board effectiveness

The requirement for boards to conduct an annual effectiveness review has been important in encouraging boards to review periodically the way they work. To this limited extent, it has been beneficial and most companies have taken it seriously. However, practice has varied considerably. A majority of companies continue to limit their review to self-assessment; often reviews are focused on governance process rather than its impact on decision-making and the more behavioural aspects which are crucial to sound governance; committee reviews are often superficial despite the vital importance of the committees' work.

We do not advocate strengthening the Code's requirements in relation to external review: it is important that the chairman feels that the time is right for external involvement. However, we recommend that:

- In Principle A6, the Code should separate out its references to the review of the board's own performance and that of its committees. The way in which they are lumped together can lead to insufficient attention being paid to committee review. Often committees are seen as an afterthought or peripheral aspect to the review (particularly the remuneration and nomination committees) whereas an in-depth review of each committee separately is often the most important and beneficial part of it. The complexity and importance of committee work and effectiveness is often underestimated and needs bringing much more to the forefront of the effectiveness review. A separate provision should set out the importance of conducting standalone and thorough reviews of committee work. These should also look at how the committees liaise with each other – the importance of effective linkages between the different parts of the governance structure is often not recognised.

- The Code should change the language used by removing references to board "evaluation". The purpose of the annual review should be to identify opportunities for further development or "continuous improvement". It should not be an exercise whose objective is to determine whether or not the board has been "effective", with a pass or fail score, yet some boards appear to approach it in this way. Use of more forward-looking language such as "board development review" might help shift mindsets and cause boards to welcome it as an opportunity rather than see it as an annual chore. Also it might help directors think more positively about individual development: the Code appears to have had little impact on attitudes towards director training.

- More emphasis should be given to the need for boards to report on their activity during the year in relation to their objectives (as discussed above) and the nature of their annual review – particularly in relation to committee review. Pressure to improve reporting in this area is, over time, likely to be more effective than requiring external review or being more prescriptive in how boards should undertake self-assessment.

- The quality of board assessments varies widely. Given the fundamental importance of the annual review to strengthening board governance and the operation of a "comply or explain" approach, the FRC should consider undertaking a periodic review of a sample of board assessments , whether self-assessment or external. It should then produce a report (on a strictly no names basis) on how practice, both good and bad, is developing with the aim of helping to improve the quality of reviews over time. We recognise that there may be considerable sensitivities to be managed, in boardrooms and amongst providers of independent assessment services, as well as resource implications for the FRC. However, we believe the idea merits consideration.

4 Joiners/leavers

- Often an independent non-executive director who joins a board will, after (say) six months have numerous questions about the way both the board and the company work eg its governance, the assurance structures, the risks, the primary business drivers, the logic of the business model. There will often be benefit to giving a new joiner a structured opportunity to raise these questions before they become part of the organisational tapestry and start seeing issues through the corporate or board lens.

- Similarly, a leaving director may feel freer to raise concerns when released from the pressure to work within a consensual board culture. Again, a structured opportunity ("leaving interview") may bring to the surface important issues which otherwise are held back. (Ideally they would already have been raised, of course, but this expectation fails to take into account the behavioural/relationship context within which directors often have to operate.)

- We recommend that the Code should include guidance that the Chairman and Senior Independent Director should arrange structured discussions with "joiners and leavers" to help ensure that concerns are captured or questions answered. A summary of the discussions and the answers should be shared with the full board. The annual governance report to shareholders should also refer to these discussions.

5 Remuneration oversight

- In this crucial area, the Code guidance is very limited. Too often remuneration committee activity is limited to executive director compensation rather than considering more widely the impact of reward strategies and policies on risk taking, ethics and organisational culture. The Code does little to set out the wider role that the committee needs to take in ensuring effective oversight of a crucial influence on the company's performance and behaviour.

- The Code should include more guidance for remuneration committees along the lines of Principle C.3 and the Smith Guidance.

6 Risk oversight

- Although the FRC's review of the operation of Turnbull suggested no need for significant changes, this was conducted in a different economic environment and before the weaknesses in risk management had been exposed by developments over the past year.

- In our view, the principles underlying Turnbull are sound, but many boards place too much emphasis on "the Turnbull process". Board review of "compliance with Turnbull" is often limited and has become increasingly rote. Board reports on internal control and Turnbull compliance are often boilerplate and give little assurance that boards or audit/risk committees have undertaken a thorough review.

- Responsibility for oversight of risk management often appears to fall between the board (which usually does not have sufficient time for detailed review) and the audit committee (who may well be focused on financial reporting and may not be inclined to, or comfortable with, oversight of operational risk management). The review of internal control can tend to be limited to financial reporting risks rather than covering the full risk spectrum. There can often appear to be confusion between "risk oversight" and "risk management". Also there is a tendency for board reviews of risk to be dependent on high-level summaries and narrowly-drawn management presentations, with limited board understanding of the risk identification process and the quality of assurance over risk management systems.

- We have also observed that there is frequently some uncertainty about risk appetite or "risk tolerance": how it should be expressed, who is responsible for it, and what it should be used for. In our view risk tolerance should be expressed in such a way that it can be used by the board to communicate to the whole organisation the required attitude towards risk-taking. It is of such importance that it is a matter for the whole board and not for delegation to a committee.

- We suggest that the Code include more precise and fuller guidance on the role of the board (and committees) in overseeing risk-taking, the effectiveness of the risk management response and the alignment of these with the Board's agreed risk tolerance. More emphasis should be given to the need for boards to report specifically on their approach to risk review and to assessing the effectiveness of risk management.

- Depending on the outcome of the current review of the Code and the Walker review, there may be a case for reworking the Turnbull guidance to provide greater clarity on the responsibilities of boards in this area.

We would be pleased to discuss these comments and suggestions in more detail if that would be of help.

Yours sincerely

Richard Sheath

Direct Line: 020 7220 6583
E-mail: richard.sheath@independentaudit.com