

**Review of the Effectiveness of the Combined Code
Call for Evidence March 2009**

Submitted by:

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Personal details

I am a chartered accountant having trained with Arthur Young (now Ernst and Young) with an undergraduate degree in Economics and Accounting (Newcastle) and a Masters degree in International Accounting and Finance (Glasgow). I have published articles on accounting and disclosure in a number of respected journals including the British Accounting Review and Accounting, Auditing and Accountability Journal. My research interests are in voluntary disclosure, international accounting and corporate governance. I have lectured in accounting, auditing and corporate governance for in excess of twenty years. I previously taught Auditing, Financial Accounting and Economics at The Financial Training Company (now Kaplan Financial).

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Scope of this submission

This response focuses on the question asked in paragraph 11 of the March 2009 Review of the Effectiveness of the Combined Code - Call for Evidence. In particular, the questions addressed by this response include: “Is the comply or explain mechanism operating effectively and, if not, how might its operation be improved” and “Views are invited on the usefulness of company disclosures”.

Background to submission

These comments and recommendations reflect the work carried out on my PhD and associated research at University College Dublin. They represent the comments of the author only. My work is based on the 2004/5 ‘first’ implementation of the Combined Code 2003: however, I believe they are relevant to the subsequent iterations of the Code (2006 and 2008). My work involves an examination of explanations given for non-compliance by FTSE 350 companies. The work comprised content analysis of certain compliance statements triangulated by questionnaires and focus groups. The focus groups to date have involved people with considerable experience in the area of business and corporate governance.

The FRC takes the view that “it is for shareholders and others to evaluate the company’s statement” (preamble to the various versions of the Code). One of the outcomes of my work is to suggest and disseminate ways of improving the quality of compliance statements and explanations. This document makes five recommendations to the Financial Reporting Council.

Recommendation 1: Positioning of compliance statements

Compliance statements should be clearly identifiable. Ideally, they should be located at the start of the Corporate Governance report. The company should clearly list any non-compliant items.

Compliance statement disclosure varies from company to company and thus it can be difficult to compare and assess different companies’ compliance. It is not always straightforward to locate either the compliance statement itself or the specific items

for which the company is admitting non-compliance. In particular, it can be problematic to distinguish between companies explaining how they are applying the Code and where they are explaining non-compliance. It should be easy to recognise the items with which the company is not complying and is therefore giving an explanation.

In my opinion the best position for the statement is at the start of the Corporate Governance report. Readers can then read the report in the light of this. Evidence gathered from questionnaires and focus groups also supported this. The worst position (again, this is supported by questionnaire responses) was where information was hidden in the middle of the report or spread throughout the report. It is felt that companies should not be able to hide the statement or its contents. In some reports one reads that ‘the company complies except where otherwise indicated’ (or similar) and non-compliance is spread throughout the report. This makes it particularly difficult for the reader to ascertain the situation. It is felt that this practice should be strongly discouraged. Comments from a focus group, which support that view, are:

“The one thing I would say is that you shouldn’t have to search for it”

“To scatter the information around ... (was) only slightly better than not giving it at all”

Recommendation 2: Details provided in compliance statements

Compliance statements should contain details of non-compliance, the relevant Code section and an explanation.

It is essential that readers can determine the nature of non-compliance. Thus, the compliance statement should not only provide a description of the non-compliance with the explanation but also provide the details of the section of the Code. Without the precise Code section, it is sometimes difficult to establish which item has not been complied with. It is preferable that all the non-compliant items are located together with the Code reference, details and explanation. Without those three parts, explanations are incomplete and may be subject to misinterpretation. Research based around questionnaire and focus groups indicated that participants agreed with this suggestion. It would also be helpful if companies disclose how many breaches of the Code they are admitting to.

Recommendation 3: Length and readability of explanations

Explanations should be adequately detailed so that shareholders can make a proper judgement as to their appropriateness. They should be written in simple language so that shareholders and others can easily understand the reasons for non-compliance. They should also avoid the use of manipulative language designed to underplay non-compliance.

Details of non-compliance and explanations can vary considerably in terms of length. Very brief disclosures are unlikely to be able to satisfy the three areas described in (2) above. Explanations should be sufficiently detailed for readers to understand exactly what the issue is and the reason for non-compliance. From my own experience, based on content analysis, explanations with fewer than 30 words are unlikely to be effective although clearly it depends on the specific violation. At the other end of the spectrum, an excessive number of words is also unlikely to be effective.

If shareholders are to be able to understand compliance statements and explanations, they should be written in simple English. Work done as part of my research found that companies tended to produce explanations which were difficult to understand. Using the 'Flesch' scale, almost all descriptions of non-compliance and associated explanations fell within the 'difficult' or 'very difficult' interpretation of that scale. Given the FRC intends that 'shareholders and others' should evaluate company statements, then the use of English should be as simple and as clear as possible. If the sentences are complex in structure or language then only specialists are likely to be able to fully understand and interpret them. In the focus groups conducted as part of my research, participants also emphasised the need for the use of clear straightforward English.

It is felt companies should construct their compliance statements more carefully and avoid words which might be seen as manipulative. Some companies refer to 'highest' standards of corporate governance and these sorts of words should be avoided particularly if they are accompanied by a number of items of non-compliance. The number of items of non-compliance should be clearly stated and unrelated items should not be combined to imply fewer items of non-compliance. Companies should

not claim ‘full’ compliance or claim the Code is ‘fully’ complied with when, in fact, elsewhere in the report, items of non-compliance are listed. These sorts of phrases are not helpful to readers and are likely to confuse them unless they have specialist knowledge.

Recommendation 4: Specificity of explanations

Explanations should be specific ensuring that the reasons for non-compliance are pertinent and adequate.

The validity of the ‘comply or explain’ system is ultimately tested by examining explanations. If explanations are missing or written in general terms, this can undermine the whole system. Part of my research examined the specificity of explanations. Whilst this is a very subjective notion, my research discovered that a number of explanations were very general and did not really explain why non-compliance was necessary or desirable. Some companies do not provide any explanation at all. Focus group respondents felt that “explanations varied from the mundane to non-existent”. Companies should be encouraged to examine carefully their own explanations, ensure they are fulsome and capture the reason for non-compliance.

The Code applies for the whole year and therefore it is also suggested that companies should still provide explanations where they do not comply for part of the year. This again, was supported by focus group comment.

Recommendation 5: Review of compliance statements and explanations

The Financial Reporting Council should consider the need to instigate some sort of oversight for ‘comply or explain’ disclosures. It is believed, that some kind of supervised self-regulation is likely to lead to higher quality compliance statements and explanations for non-compliance.

Part of my work involved focus groups with experienced business people who had studied aspects of corporate governance as part of a diploma course aimed at business managers (typically qualified to MBA or equivalent). An issue raised during one of

the focus groups was the policing of the ‘comply or explain’ system. Comments included:

“I would say it is potentially critical but in practice largely ignored”

“There is very little sanction for failure to adequately explain. Lip service is played to ‘comply or explain’ without any substantive follow through”

“It seemswe need to think in taking a more substantive stance in interrogating it”

My own work together with consideration of these comments suggests that there is some merit in considering the review of compliance statements to ensure that the system is working properly. The question is, of course, who could or would carry out such a review. At present, no one checks the correctness of the compliance statement or gives an opinion on its correctness - it is left to shareholders or others. A high proportion of my fieldwork respondents felt that auditors could do this (they were asked to ignore current practice). Another possibility is for auditors to carry out a ‘reasonableness’ test on explanations. Again, a high proportion of respondents to questionnaires felt that auditors could carry out a ‘reasonableness’ test. Although auditors might balk at this, they could at least check that the various components described in (2) above were present. This small step alone would improve the quality of compliance statement and associated explanations. Whether auditors carry out a review or it is performed by another body, it is felt that companies would produce higher quality explanations and compliance statements precisely because they knew they were subject to scrutiny. For this reason, it seems worth considering some sort of ‘supervised self-regulation’ system.

It is accepted that this is a difficult area. However, it is worth some consideration as without some examination of compliance statements the ‘comply or explain’ system is always going to be the subject of some criticism, which ultimately will undermine its effectiveness. In order to protect the viability of the current self-regulation system some changes need to be considered. If things are to remain the same, then some changes will have to be made.

Concluding Comments

In one of the focus groups I carried out, one member stated:

“To make the whole system of corporate governance work the ‘comply or explain’ approach is a vital ingredient.”

The ‘comply or explain’ system adopted in Britain has been copied or adapted by a number of different countries. It is for that and other reasons that the system should work properly and be seen to work properly. Explanations for non-compliance need to be properly crafted. Non-compliance with an explanation needs to be seen as ‘equal value’ to compliance. Companies should not feel the need to falsely claim compliance (note: no evidence of this is presented), in order to avoid writing explanations. Nevertheless, those explanations should be fulsome and it is worth considering ways of improving the quality of those explanations.

This short response is based on my PhD research to date and makes some suggestions as to how the system can be made more effective. It is hoped that these five recommendations will be of use to the FRC when considering revisions to the Code and the monitoring of its application in practice.