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Dear Mr Hodge

Review of the Effectiveness of the Combined Code

I am responding to the FRC's call for comments on the Combined Code. I have a number of comments on some of the specifics of the existing Code which are shown on the following pages. In my view, the time is right for some significant amendments to and augmentation of the existing Code.

Please feel free to contact me if there are any points which need further clarification. If you detect any errors of fact in my comments, I would equally be grateful if you could inform me accordingly.

Please note that, while I am Head of Group Operational Audit for DS Smith Plc and also the current President of the Institute of Internal Auditors – UK and Ireland (IIA), I wish to make it clear that I am writing purely in my personal capacity and not on behalf of my employer or the IIA. Although I have consulted others in preparing this note, any errors or misapprehensions are entirely my own responsibility for which I apologise in advance.

Yours sincerely

Philip Ratcliffe

1. The value of independent non-executive directors (INEDs)

The overall effectiveness of the Combined Code relies implicitly to a very great extent on the value of an independent non-executive director as a foil to any potential excesses and abuses of executive management. It assumes that the right INEDs will be able to identify when executive management does something inappropriate, and that they will be able to hold executive management to account and redress the situation where necessary.

The rash of corporate failures and downgradings in recent months has been widely attributed not least to failures of corporate governance, and INEDs are a cornerstone of current concepts of corporate governance. The centrality and validity of this concept must therefore be called into question.

If we examine the qualities required of an INED they include the following:

- They have never worked in the company, or at least, not recently, and therefore have no experience of the industry by that route
- They are almost certainly not working for a competitor in the same industry as that would represent a clear conflict of interest
- Whereas they could in theory work in the same industry in another country, that is unlikely in practice.

It is worth therefore making explicit that which does not normally need to be said – INEDs bring no detailed experience of the company of which they are board members or any in-depth knowledge of the specifics of its business. Boards are now dominated by INEDs, who now by definition come with no in-depth knowledge or experience of the details of the business.

Under British law, INEDs are equally responsible for a company whose business they cannot fully understand as the chief executive. In view of the foregoing, by definition, INEDs are responsible for companies on whose business they are complete amateurs at the time they take up their board directorships. Can this relative ignorance really be a good thing? The pool of expertise which is ruled out in practice by the current regulations is that of former executives of the business. Whilst encouraging their involvement with boards is not without its perils, there should be greater scope than at present for bringing these unique skills and experience to the benefit of boards.

> ***Implication: The Combined Code should review and relax its requirements for independence so that there is less of a barrier to former executive directors being NEDs. There may need to be safeguards or limits to their roles, especially on board committees.***

2. Balance on the Board

The current Combined Code requires '…a balance of executive and non-executive directors' (Main principle A.3) and '…at least half the board … should comprise [independent] non-executive directors' (A.3.2.). This requirement was introduced by the Higgs report. Yet its impact over the years since it was introduced has resulted in some probably unintended

consequences. We now see many boards where, far from a balance, there is a preponderance of INEDs, and where the only executive director presence is that of the Chief Executive and the Finance Director. A recent report by Grant Thornton has shown that boards have shrunk from an average of 9.5 to 8.5 and the executive directors from an average of 3.9 to 3.4. This means that in many companies the INEDs can only see the operations of the company through the lens of the Chief Executive and have no easy way in board meetings of cross-checking that view with any other executive director, other than for financial matters.

The further corollary of this situation is that the legal board, subject to the weight of corporate governance codes, is shadowed by a de facto board of executive managers who are completely unbound by many of the tenets of corporate governance developed since Cadbury. The Combined Code has inadvertently created a two-tier board structure, where the second tier is all but invisible and out of the range of corporate governance codes. This cannot be a good thing for transparency.

> ***Implication: There should also be greater enforcement and/or encouragement for boards to be more truly balanced between executive and non-executive directors, such as a requirement that a minimum of 40% of boards shall be executive and a minimum of 40% shall be non-executive.***

3. Effectiveness reviews

The Combined Code places great store on a range of effectiveness reviews. These include:

- The performance evaluation of the Board
- The group's system of internal controls
- The internal audit function
- The external audit process
- The audit committee

The weakness of the present Code from the point of view of stakeholders is that Annual Reports are only required to confirm that an effectiveness review has been carried out; no clue is normally given as to the results of these reviews. This is surely completely unsatisfactory. There is no transparency. There is an implicit presumption that any significant adverse findings from a review might be hinted at but there is no requirement to report them. While I understand there are perceived to be legal barriers and considerable risks to directors in making known the results of such effectiveness reviews, it is surely in the greater public interest that the results of the reviews should be published at least in the broadest terms e.g. 'broadly satisfactory' or 'generally satisfactory with the material exception of …'. The FRC clearly has to acknowledge the difficulties associated with making the results of effectiveness reviews public, but should lobby for legislative changes to permit the publication of meaningful results of these reviews where this would be necessary in order to achieve the desired transparency.

> ***Implication: The FRC should seek to find a way in which directors can make public a clear indication of the results of their effectiveness reviews, including the reporting of any material adverse findings.***

4. Internal audit and the Combined Code

The current Combined Code, when it was introduced, encouraged many businesses to develop their internal audit functions and many businesses will have benefited substantially as a result. Since then, the Institute of Internal Auditors has updated and revised its internationally-recognised Standards for internal auditing, which represent a benchmark level of good practice. The Combined Code should recognise these Standards and require compliance with them as a criterion in the reviews of the effectiveness of internal audit.

The Combined Code should go further than it currently does in specifying the need for, and the role of, internal audit. The FRC should carefully consider the requirements of the draft King III report from South Africa as an example of leading-edge practice.

The current requirement C.3.5 to 'comply or explain' (why there is no internal audit function) should be strengthened. It should be the expectation that there will be an effective internal audit function in all but the most exceptional circumstances.

Implications:

- ***The FRC should recognise the IIA's Standards for Internal Auditing as a benchmark for internal audit practice.***
- ***The FRC should review the draft King III with regard to internal audit and consider adopting its measures.***
- ***Companies should be expected to have an effective internal audit function in all but the most exceptional circumstances.***

5. Risk management

It is clear that the current economic crisis and the credit crunch which preceded it have shown that many boards' risk management practices have not been up to the task. It seems that in some cases, basic elements of the business model of the enterprise have not been understood or articulated. The Code should go much further in relation to risk management than the limited mentions made in C.2.1 and C.3.2. The weakness (under C.3.2) of asking the audit committee to review the risk management systems is that audit committees are primarily concerned with financial controls and financial statements, and therefore predisposed to give them priority, rather than general management matters. This is reinforced by the requirement that 'at least one member of the audit committee has recent and relevant financial experience'; none is required to have experience of the business of the enterprise.

Implications:
The Code should require Boards:

- ***to make explicit and review the business model(s) of the company***
- ***to identify those matters critical to the success of the business model including matters which might otherwise be taken as implicit (e.g. the availability of wholesale money market funds)***
- ***to identify those matters which it is critical to avoid but where avoidance will of itself not ensure success (e.g. a factory fire, an accounting breakdown)***
- ***to identify the risks attendant on each of these, together with an assessment of the adequacy of the related risk mitigation arrangements.***

Boards should also be required to identify temporary or transient risks – such as those arising from implementing a new computer system – and satisfy themselves with regard to the mitigation arrangements.

6. Presentation of the requirements of the Combined Code

The Code has grown up through the development of a number of reports since the early 1990s. As a result, its structure today does not lend itself to as easy reference as is ideally desirable, as the requirements are spread over at least three separate documents (the Code, what was 'Smith', and what was 'Higgs'). This compares unfavourably with the South African code, whereby all the requirements are gathered together in one document such as the draft 'King III'.

Implications: future editions of the 'Combined Code' should be truly 'combined', and consolidated into one document.

Philip Ratcliffe
May 2009