

Mr Chris Hodge  
Corporate Governance Unit  
Financial Reporting Council  
5th Floor, Aldwych House  
71-91 Aldwych  
London  
WC2B 4HN

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Direct line: 0207 951 4666

Email: rheath@uk.ey.com

By post and email: [codereview@frc.org.uk](mailto:codereview@frc.org.uk)

Dear Mr Hodge

## Review of the Combined Code 2009

### INTRODUCTION

1. Ernst & Young LLP welcomes the opportunity to comment on *Review of the Effectiveness of the Combined Code, Call for Evidence 2009* ("the Consultation") issued by the Financial Reporting Council ("FRC").
2. We acknowledge that since 2003 the FRC has reviewed the Combined Code ("the Code") every two years. In our view this is an effective way to make sure the Code remains fit for purpose on an ongoing basis. For this reason we believe it is important that we remain actively engaged with the FRC on successive reviews including this one.
3. Of course we recognise the importance of this particular review, given the financial crisis and the work of Sir David Walker and others in the area of corporate governance and regulatory reform. This is why we decided to take a step back and reappraise the Code as if it were new, to see if anything should be "put right" in light of current circumstances. For this reason we could not confine our response to the questions raised in the consultation.

### OVERALL OBSERVATIONS

#### The Code is fit for purpose

4. In our opinion the majority of UK business sectors have not practised "poor" corporate governance - a view many stakeholders and commentators share - and what constitutes "good" corporate governance can already be referenced under one or more principles in the Code. Therefore the Code remains fit for purpose, notwithstanding that the purpose to which we refer (explained clearly in the Code) has never been greater. This is because the financial crisis has placed under the closest scrutiny the governance of all companies, including but not limited to financial institutions.



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5. That said, the key issues faced by financial institutions (involving but by no means solely attributable to corporate governance) are in many respects unique to this sector and are being addressed accordingly by the government and FSA. Our understanding is that their work is progressing well, and it seems likely that regulatory change will come to this sector in the not too distant future. In our view this targeted response seems appropriate under the circumstances, but as with any other regulatory change it should be preceded with, and shaped by, a thorough impact assessment.

### **The Code does not require fixing**

6. Unfortunately, there can be no *containment* of the effects of the financial crisis, but we believe there can and should be a *confinement* of the solution. This is because we can find no evidence to justify the same or similar regulatory action being applied to sectors outside banking and finance, especially in regards to corporate governance and the Code. For example, it is unlikely in our view that other company sectors and respective infrastructures have to manage the same high level of systemic risk. So it follows that corporate governance and particularly risk management should have greater significance in banking and finance compared with other sectors.
7. Ironically, we believe that if there was a cross-sector change in the regulation of these activities, it could have the opposite effect to the one intended for the banking sector. This is because it would involve tampering with a set of principles which have successfully helped to promote good governance across most business sectors in the UK.
8. Finally, it is important to view the Code within the context of the Companies Act 2006, which introduced new statutory duties for directors including a requirement to promote the success of the company<sup>1</sup> (s172) and the statutory duty to exercise independent judgement (s173). In our view the Code, and the combined effects of the Act, provide a comprehensive regulatory framework and set of principles.
9. However, if the financial crisis has raised any doubts - rightly or wrongly - about corporate governance in the UK, we believe it is an issue about the output of the Code rather than its input. This is because compliance with the Code tends to focus on inputs (e.g., Has an independent chairman been appointed? Has an audit committee been established?) rather than outputs (e.g., Are the chairman's judgements independent? Are members of the audit committee fully conversant with the technical issues raised by the auditor?).

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<sup>1</sup> s172 of the Act prescribes the factors that directors should have regard to in discharging this statutory duty and such factors include:

- (a) the likely consequences of any decision in the long term,
- (b) the interests of the company's employees,
- (c) the need to foster the company's business relationships with suppliers, customers and others,
- (d) the impact of the company's operations on the community and the environment,
- (e) the desirability of the company maintaining a reputation for high standards of business conduct, and
- (f) the need to act fairly as between members of the company.



### Guidance and application

10. As we said in our introduction, the periodic review of the Code is important. On this occasion it has also prompted companies and their stakeholders to discuss how they apply the Code, especially in the boardroom and within the context of the complexities of their businesses.
11. We welcome this dialogue and would like to share some of our own thoughts as to how the application of the Code could be enhanced further, perhaps with evidenced-based changes to the Turnbull guidance.

### Composition and effectiveness of the board

12. There is an opportunity in our view for boards to reappraise the way they operate. For example, we believe that:
  - Chairmen and senior non-executive directors might consider whether they can find more ways to engage *together* with shareholders, to reinforce and amplify independent views on the performance of their businesses. In our view compliance should be a creative rather than just affirmative process e.g., directors should be innovative in the way they apply governance principles.
  - More boards might wish to consider the provision of discrete company secretarial support to non-executive directors, together with a budget for their exclusive use. This could help these directors to: conduct independent research; seek independent advice; review board papers earlier; and, if required, analyse the content of these papers more comprehensively than before.
  - Senior non-executive directors could be encouraged to review more often the relationship between chairmen and CEOs, as well as the overall performance of boards, with the support of independent consultants. The output could be used to identify and help resolve board room issues (e.g., a need for non-executive directors to augment their understanding of risks in the business), whilst keeping shareholders fully informed.
  - Chairmen could perhaps seek new ways to encourage non-executive directors to operate more cohesively, perhaps meeting together more often so they can address issues *collectively* in board meetings. This could help to prioritise issues for discussion and provide more weight to specific lines of independent enquiry and challenge.
  - Boards might also wish to consider the extent to which chairmen and senior non-executive directors are independent of each other. There may be circumstances where both parties have worked together in the past in another company, or one may have succeeded the other in previous roles. This might bring benefits to a board in terms of knowledge sharing, but a perceived lack of independence between the two might be regarded as a threat to the independence of their respective roles.

### *Dialogue with institutional shareholders*

- We believe it is incumbent upon shareholders, and those institutions which represent the majority of private investors, to encourage boards to explain more fully which areas of the Code they have avoided and why. However, first and foremost, boards should be clear about the identity of their shareholders and their respective information requirements: i.e., what information they *need* and how they prefer to *receive* it. This should help boards to inform different categories of shareholder with a level of detail and means of delivery appropriate to the requirements of each category.
- Depending on the nature of a particular company's business, it might help if more forward-looking risk assessments are shared and discussed with investors, perhaps by means of an independent risk committee. We believe that managing or controlling risk is only as effective as the extent to which relevant stakeholders understand the scale of that risk and how a company intends to deal with it.<sup>2</sup>

## CONCLUSION

We believe the financial crisis provides an invaluable opportunity for boards to reassess the way they operate. This is particularly relevant for banks and other financial institutions, but no less important for other companies regardless of sector.

However, in our view every facet of what constitutes "good" corporate governance can already be referenced under one or more principles in the Code. Therefore we conclude that the Code must be fit for purpose, especially since these principles encourage flexible compliance and discourage inflexible box ticking.

If anything needs to change in the aftermath of the crisis, we suggest it is primarily the way boards and shareholders engage with each other and apply the principles of the Code for their mutual benefit. For this reason it would be wrong in our opinion to jeopardise the future success of the Code by tampering with the one thing that seems to work best – its principles.

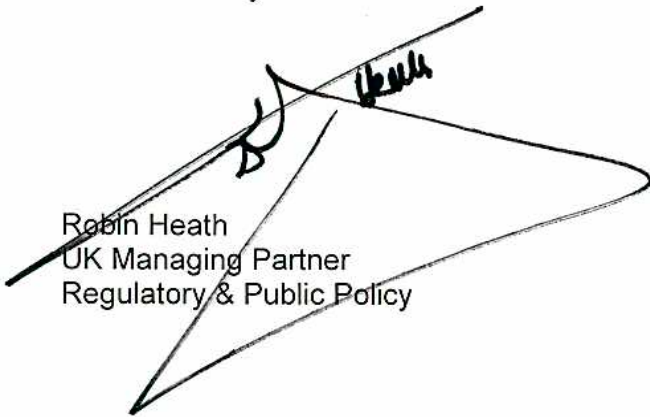
We are grateful to the FRC for publishing this consultation and we hope you have found our comments helpful. If you would find it useful, colleagues in our firm are available to discuss further any of the points we have raised.

We wish you every success with the rest of the consultation process and encourage you to publish all non-confidential responses, including this one, shortly after the closing date. We look forward to reading the results.

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<sup>2</sup> Quoted companies are already required under the Companies Act 2006 (s417(5)) to disclose in their Business Review the main trends and factors likely to affect the future development, performance and position of their business.

Yours sincerely



Robin Heath  
UK Managing Partner  
Regulatory & Public Policy