Chartered Institute of Management Accountants

MAKING THE COMBINED CODE MORE EFFECTIVE

CIMA comments on the Financial Reporting Council's review of the **effectiveness of the combined code**

Introduction

The Financial Reporting Council (FRC) is currently seeking views from a broad range of stakeholders and interested parties on any aspect of the Combined Code. This is in response to the current economic and financial crisis. It also takes place alongside Sir David Walker's review of the governance of banks. The FRC has requested comments by 29 May 2009 and changes that are proposed to the code will be the subject of further consultation.

In the current climate, there is an undoubted need for the code to be reviewed. The last major review of the code was undertaken in response to the situation at the turn of the century when significant amounts of shareholder value were destroyed by organisations such as Enron in the US and Marconi in the UK. As part of the current review, it would be useful to consider what lessons were drawn from this earlier period and whether in fact they have been fully acted upon. In conjunction with the International Federation of Accountants (IFAC), CIMA undertook a series of case studies to investigate what could be learnt as a consequence of these earlier corporate failings. The findings were published in a 2004 report, *Enterprise governance – getting the balance right* and we have included the key lessons in Appendix 1. As mentioned later in this paper, we would be very happy to discuss this and any of our other relevant work in more detail.

However, in terms of formulating an appropriate policy response, we need to exercise a certain degree of caution. While there is clearly a powerful political imperative for change, doing nothing is not an option in the current climate, it is equally vital that policy makers do not respond with ill considered measures with an adverse impact on governance and the long-term prosperity of the UK. There is a particular risk of drawing conclusions from what was an exceptional situation in a particular sector and then imposing a governance solution on the rest of the corporate sector that is inappropriate.

This can best be avoided by ensuring that there is robust evidence based research to identify whether there have been significant corporate governance failings beyond the financial sector with its unique problems. It will also be crucial to examine the conclusions of the Walker Review very carefully to ensure that we apply only those recommendations that are relevant to the corporate sector generally.

CIMA believes that the FRC has a potent role to play in championing good governance. A part of this role should be to commission and disseminate research on what constitutes good governance and to undertake considered investigations into instances of major failings. Active discussion should be encouraged as to how the role of the FRC should be defined in this regard and what resources and new powers would be required to support it. We will explore the importance of evidence based research later in this paper, but in the meantime, we note that as part of its evidence gathering phase, the FRC is inviting comments from interested parties, but that it is also meeting directors and investors to obtain views, studying corporate governance statements in annual reports and analysing existing and new research. However, we believe that the FRC should also consider the need for commissioning new research. It is worth recalling that Sir Derek Higgs commissioned three major pieces of primary research as part of his review in 2002 and one of the outcomes of this consultation should be the development of possible research questions for further investigation.

Initial anecdotal views from CIMA's advisory group of directors in FTSE350 companies suggest that, while their companies are undoubtedly experiencing challenging conditions, directors do not regard these to be exacerbated or caused by shortcomings in governance. If anything, one director has commented that it is recent governance reforms that have helped companies to weather the storms more effectively (see quote on page three). Clearly, these initial impressions would need to be substantiated, but they do give a useful starting point for further research.

In addition to exploring what has gone wrong, a second strand of research would focus on the effectiveness of the current UK corporate governance model and whether there are alternative models that should be explored over the medium-term. The scale of the financial crisis is such that searching questions are understandably being asked about the future shape of capitalism. This is unsurprising. But at this stage, it is not possible to answer such broad questions. All that can reasonably be done is develop the right questions that need to be asked to ensure informed debate over the medium-term. The identification of such questions would be a useful outcome of this current review.

Comments from CIMA FTSE350 directors

I don't believe that there is anything fundamentally wrong with the Combined Code as such. As ever, the issues arise on the practical application of that code.

Tighter governance standards, especially outside the banking sector, would be exactly the wrong solution, instead what the FRC needs to focus on is what makes a board effective and the answer is certainly not more rules or more numbers.

On the whole, I believe the current Combined Code works well… I think we should be wary of carrying out wholesale changes to the code because of the failure of risk controls largely at a few financial services firms during the last 18 months or so. In fact, if we exclude the financial services sector, it is noteworthy that so few UK listed companies have failed in this recession. Of course, it is possible that there are a significant number of failures yet to come, but I suspect that there will not be very many, and one reason is that good balanced corporate governance practices have been deployed in most listed companies.

The remainder of this paper therefore considers:

- What improvements could usefully be made to the code in the short-term to help boards be more effective? In developing these proposals, we have consulted with CIMA members who are directors of FTSE350 companies. We have also held informal discussions with a wide range of other interested parties including investors and auditors.
- Questions that are worthy of further consideration and research in the medium to long-term.

In recent years, CIMA has dedicated extensive effort and resources to researching and developing best practice in governance issues. The conclusions of this work underpin the views set out in this paper and are summarised below:

- The importance of good narrative reporting cannot be over estimated. Not only does it provide the information that investors need, but it also drives better internal reporting. This in turn is a critical determinant of how well a company is managed by its executive team and whether non-executive directors (NEDs) are in a position to exercise effective governance. Inevitably, better narrative reporting may need additional disclosure. In such cases, it will clearly be important to consider issues surrounding commercially sensitive material although this is sometimes used as a convenient excuse for non-disclosure. More importantly, is the appetite for more disclosure of 'forward-looking' information and it is important that there is a well recognised 'safe-harbour' protection for statements made in good faith.
- CIMA, in conjunction with PricewaterhouseCoopers and Radley Yeldar, a communications consultancy, has formed the Report Leadership Group (RLG) to develop simple practical ways to improve both narrative and financial reporting.

The work is built on the premise that corporate reporting should be more informative and accessible without swamping investors in unnecessary detail. The RLG has made a separate submission to both the Walker and FRC reviews. This emphasises the crucial role of reporting in effective governance and recommends that a key action coming out of both reviews should be for a fundamental review of the reporting model with the objective of understanding how it can be enhanced to support more effective governance and shareholder oversight. The RLG response is enclosed for ease of reference at Appendix 3
and should be read in conjunction with this response.

- CIMA's work on enterprise governance (undertaken jointly with IFAC) emphasised the importance of effective board oversight of strategy as a key component of good governance. As indicated earlier, the key lessons from this project are included in Appendix 1. CIMA followed up this initial work by developing a process driven tool (the CIMA Strategic Scorecard™) which was designed to assist boards to engage in strategic development more effectively. Background on the scorecard is included in Appendix 2.

Summary of CIMA's key recommendations

Issues to address – ensure adequate evidence based research to inform policy proposals and to promote good governance in the long-term.

1. Review lessons drawn from previous corporate governance failures and assess whether they have been fully acted upon.
2. Research whether there have been any major governance failings beyond the financial sector and the lessons that can be drawn.
3. Identify questions to assess the overall effectiveness of the current UK governance model and possible alternative models for further research over the medium-term.
4. Consider ways in which the FRC could play a more proactive role as champion of good governance and what resources or new powers would be required to support this.

Issues to address – whether current regulatory arrangements for maintenance and oversight of the Combined Code are fit for purpose.

5. As a longer-term project, review the current regulatory arrangements for the Combined Code and consider whether responsibility for enforcement should be taken over by the Financial Reporting Review Panel (FRRP).

Issues to address – amendments to the Combined Code that would enhance board effectiveness in the short-term.

6. Reinforce the preamble of the code to reflect the statutory statement of directors' duties but in a way that emphasises both the importance of the creation of long-term sustainable value and the role of the company in a well functioning society.
7. Consider the need for additional guidance on prior qualifications and experience required for NEDs and whether training and continuing professional development should be made mandatory.
8. Reinforce the requirements for board balance by limiting the number of NEDs who hold executive directorships elsewhere. In addition, require greater disclosure on the commitments and contributions of board members to permit more effective scrutiny and challenge by shareholders. Overall, there needs to be an adequate balance on the board between NEDs who have considerable insight and experience to offer, but are very 'time poor' and those who are, in effect, full-time NEDs. Consider research into the optimum use of board time and the use of committees in achieving board effectiveness. This could provide outcomes that the FRC could champion as good governance – see 4 above.
9. Strengthen the board evaluation process by specifying areas to be considered as part of the board evaluation process more explicitly and requiring that the performance evaluation should be subject to independent external review. The performance evaluation should also involve the requirement to seek the views of senior management reporting to the chief executive as they can provide a good insight into board dynamics. The process for both the evaluation and the external review should be disclosed in the annual report.
10. The code should emphasise the need for greater connectivity between board and management by clarifying the role of senior management in supporting good governance and by strengthening the obligation on management to provide appropriate information to the board.
11. Provide greater emphasis on the roles of the chairman and company secretary in promoting board effectiveness and include recommendation that companies should consider whether the company secretary should report directly to the chairman.
12. The code should provide supplementary guidance similar to the Turnbull Guidance as to the scope of information that directors need to consider in relation to strategic issues. The code should also require boards to develop an appropriate and robust process for overseeing the company's strategy and that it should disclose this process in the annual report. This should emphasise the importance of stress testing the robustness of the business model. It should also include reference to the scope and quality of the information that the directors receive about the business as well as a broad explanation of the nature of issues dealt with over the year.
13. Companies should be required to consider annually the need for a dedicated resource to support the NEDs and should disclose that they have done so in the annual report.
14. Boards should consider ways in which they can encourage constructive challenges to their working assumptions.
15. The code should include more explicit mention of the need to base rewards on long-term sustainable performance. The responsibilities of the remuneration committee should be extended to the overall remuneration framework of the organisation. Companies should also explain how and why their remuneration structures are consistent with their strategic aims and objectives. While we would not advocate setting limits on salary multiples, we believe that the remuneration committee should have the responsibility to consider whether the salary profile of the organisation is acceptable from an ethical perspective.
16. There should be substantial research in the medium-term to understand the profile of company ownership and how owners can play an effective role in enhancing board effectiveness.

The code response in detail

The status of the code

Paragraph 1 of the preamble to the code refers to the board discharging its duties 'in the best interests of shareholders'. Since this preamble was developed, the Companies Act 2006 has been enacted with its statutory statement of directors' duties. This obliges a director to 'act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole'. The government has clarified that success in this context means 'long-term increase in value'. Directors are also required to have regard 'amongst other matters' to:

- the likely long-term consequences of their decisions
- the interests of the company's employees
- the need to foster the company's business relationships with suppliers, customers and others
- the impact of the company's operations on the community and the environment
- the desirability of maintaining a reputation for high standards of business conduct
- the need to act fairly as between members of the company.

It may be helpful for the preamble of the code to be revised to reflect these statutory duties in more accessible i.e. non-legal language. It would also be helpful, in the context of the non-statutory code, to place additional emphasis on the company's role in society and the responsibility that the board has to run a company in a way that instils confidence and trust within its wider community. While in no way negating the priority of business imperatives such as, the need to remain competitive and the role of government in providing an appropriate and robust regulatory framework, boards should be reminded of the crucial contribution that effectively governed companies make to a well functioning society. One of the code's strengths has always been its broad applicability across all corporate sectors together with its clear intention to avoid a 'one size fits all' solution. We believe that this should remain a fundamental part of the code while recognising that for certain specific sectors, there may be a particular need for additional governance requirements and/or regulation. This also applies to the size and complexity of company and there may need to be recognition of slightly different governance requirements between, say, the FTSE100, FTSE250 and others.

Regulatory arrangements and the role of the FRC

At present, while the FRC is responsible for keeping the code under review, the Financial Service Authority (FSA) is responsible for ensuring that the appropriate statements are made in the annual report under the listing rules. It is worth considering whether this remains an adequate arrangement.

Interestingly, as part of its deliberations on the implementation of the EU Accounting Directives in 2007 which require quoted companies to take a corporate governance statement in their annual reports, the government considered whether enforcement should be by the Financial Reporting Review Panel (FRRP) or the FSA. In the event, it was decided that the FSA should enforce implementation on the grounds that this was consistent with the existing corporate governance regime and with the 'light touch' philosophy of regulation. However, some argued that FRRP enforcement would offer a more unified approach with all reporting and disclosure requirements dealt with in a consistent way.

In view of the questions raised about a 'light touch' approach, it is sensible to review the regulatory arrangements relating to corporate governance. This should entail a comparison of the current FSA regime with a possible FRRP one with pros and cons for each. That said, this is a project for the longer-term as we believe that the immediate priority is to improve board effectiveness.

Furthermore, even if these regulatory arrangements remain in place, it is appropriate for the FRC to consider assuming a more proactive role in promoting governance best practice. This could be achieved through setting out more forcefully what it considers to be good governance. As we have suggested above, this would require the FRC to be a major sponsor of governance research and it is therefore essential that adequate resources are allocated to this. A key output of such research could be the production and dissemination of case studies on what constitutes best practice in governance. This would provide a focal point for guidance on best practice in corporate governance. A further option would be to give the FRC authority to request companies to publish reports on cases where serious failings are considered to have occurred. Such reports would b e similar to the *Shareholder Report* published by UBS in April 2008 (*Shareholder Report on UBS's Write-Downs*). This report was issued at the request of the Swiss Federal Banking Commission which had requested that UBS report the key facts relevant to understanding the principal root causes leading to the sub prime losses. CIMA strongly recommends that serious consideration is given to how the FRC could play this more proactive role in governance and thus ensure that the FRC remains at the forefront of ensuring 'confidence in corporate governance and reporting' both in the UK and beyond.

The board

The code is already very comprehensive in terms of issues such as board balance and independence as well as appointments, induction and the need to ensure that directors will have sufficient time to fulfil their responsibilities. It is difficult to see how additional provisions could be added to the code itself without making the code overly prescriptive. However, it may be useful to consider additional guidance on issues such as:

- Prior qualifications and experience required together with appropriate induction and post appointment training. A more powerful move would be to make such training mandatory. The code should also emphasise that board selection should be based on future potential to contribute and not purely on past achievement.
- Assessing what experience is required and how to judge this in the context of existing skills and experience already on the board.
- Expected time commitment.

The code response in detail (continued)

One useful addition to the code itself, however, is the requirement that a board should limit the number of NEDs who also hold executive directorships elsewhere as they are the most likely to be 'time poor'.

The code should also require companies to provide an annual report on the balance of skills in the boardroom and the agreed time commitments, although as stated above, care needs to be taken not to make the code unduly prescriptive given that we do not have categorical evidence that the current principles based approach is flawed. It would also be helpful if all the current commitments and contributions of board members are disclosed clearly in the annual report to permit more effective scrutiny and challenge by shareholders. Overall, there needs to be an adequate balance on the board between NEDs who have considerable insight and experience to offer, but are very 'time poor' and those who are, in effect, full time NEDs.

A useful avenue of research would be to investigate optimum time allocation and use of committees in terms of achieving board effectiveness.

The current code includes the principle (A6) that the board should undertake formal and rigorous performance evaluation. The board is required to state in the annual report how this evaluation has been conducted. Our brief review of annual reports has revealed significant variation in the information provided and, of course, the evaluation is based on self-certification. CIMA believes that it would be useful if the areas to be considered as part of the evaluation were specified more explicitly and that the performance evaluation should be subject to independent external review. The performance evaluation should also involve the requirement to seek the views of senior management reporting to the chief executive as they can provide a good insight into board dynamics. The process for both the evaluation and obtaining the independent review should be disclosed in the annual report.

The importance of information and board connectivity

Principle A5 states that 'the board should be supplied in a timely manner with information in a form and of a quality appropriate to enable it to discharge its duties.

In terms of roles and responsibilities, the code places particular emphasis on the chairman and the company secretary. This is appropriate and indeed, CIMA believes that the code should emphasise the roles of these two positions more powerfully. The company secretary has a key role to play in governance in terms of ensuring the provision of information and the effective functioning of committees. However, companies should consider whether the company secretary should report directly to the chairman to ensure that this governance role is fully recognised.

CIMA would also like to see more emphasis placed on the role of the senior management as whole. We believe that the code should emphasise the importance of effective connectivity between the board and management in order to achieve good governance and performance. The code does state that the management has an obligation to provide information, but we believe that the code should strengthen this obligation considerably.

Companies need to take active steps to ensure that senior management (not just executive directors, but those at levels immediately below board level) have a deep understanding of their role in ensuring good governance, in particular, the importance of their providing high quality management information that supports meaningful discussion.

As part of its ongoing work on governance, the Professional Accountants in Business Committee (PAIB) of the International Federation of Accountants (IFAC) has developed an International Good Practice Guideline (IGPG), *Evaluating and Improving Governance in Organisations* (see **www.ifac.org**). A particular strength of this guidance is that it focuses on what accountants in business should do to evaluate and improve governance in their organisations. It also emphasises the board's role in overseeing strategy, an issue to which we now turn.

As an example of lessons to be learnt from the 'Enron/ Marconi era', CIMA and IFAC issued a report in February 2004, *Enterprise Governance – getting the balance right*. This identified both shortcomings in governance and strategic oversight from a series of case studies included in the report (see Appendix 1 for a summary of the key lessons). It is interesting to note that strategic failures were a key cause of difficulty in many of the companies we studied and one of the key outcomes of the report were proposals to improve strategic oversight by boards (please refer to Appendix 2 for a brief summary of this work). We believe that these issues remain pertinent and that the code would be strengthened by more explicit coverage of the board's role in strategy. It would therefore be helpful to provide supplementary guidance (similar to the Turnbull Guidance) as to the scope of information with a checklist of suitable questions that directors need to consider in relation to strategic issues.

CIMA believes that such information should include:

- The business model and its robustness. We believe that stress testing the business model is absolutely crucial and should consider issues such as major market changes such as a new competitor which is able to gain substantial market share.
- The external environment, for instance, customer needs and competitor activity.
- The internal environment such as resources and competences.
- Potential strategic options.
- Strategic implementation.
- Key strategic risks together with major operational risks that effectively have a strategic impact if they materialise.
- Boards should also consider systemic risk. When stress testing their business model, they should incorporate the impact of the 'herd instinct'. In other words, in scenario analysis, they need to consider what would happen if other organisations in the same industry all pursued the same actions or strategies.

Comment from CIMA FTSE350 director

Is it possible that its emphasis on boards exercising a greater deal of control over a wide range of risks has caused some boards to concentrate too much on the minutiae and not nearly enough on the major risks to the industry and the specific company?… In general, I suspect that board members have spent too little time discussing the implications of such matters as a major change in the pattern of consumer demand, or a major technological change, or a significant strategy change by a competitor, or a major economic recession… Perhaps any updated code should emphasise that boards should concentrate on these major business risks rather than on the operational risks on which some boards have devoted so much time?… The code would do well to remind directors that they should not try to follow the strategies of their (apparently) successful competitors without rigorously assessing the risks for them of doing so as well as the potential benefits.

As pointed out in our RLG submission (see Appendix 3) we believe that the ability of a company to explain a joined-up picture of its strategy with a clear understanding of the market(s) in which it operates and the factors that will impact it across the business cycle provides invaluable evidence as to the quality of governance within that organisation. This reinforces the emphasis earlier in this paper on the importance of effective narrative reporting.

Linked to this, the code should also include a provision that the board should develop an appropriate and robust process for overseeing strategic development and that it should disclose this process in its annual report. This should emphasise the importance of stress testing the robustness of the business model. The statement should also include reference to the scope and quality of the information that the directors receive about the business as well as an explanation in broad terms of the nature of issues dealt with over the year. (This could also give boards an opportunity to explain how much of their time is devoted to compliance related activity.)

We also believe that this disclosure should include a statement whereby the board attests that it has reviewed the key strategic areas listed above, for example, the robustness of the business model, and has taken action to address any weaknesses in a similar way as is required by the Turnbull Guidance. This is a particular area where we believe that the FRC could play a particularly useful role in articulating what good governance looks like and provide useful case studies of best practice. For example, one area that could be considered would be what are common indicators of excessive risk being taken by an organisation, for example, excessive return on investment?

We would also recommend that the code should make additional provision to support the NEDs. As the code stands at present, principle A.5.2 states that directors, especially NEDs, should have access to independent professional advice at the company's expense where they judge it necessary to discharge their responsibilities as directors. Committees should also be provided with sufficient resources to undertake their duties. We believe that the code should explicitly acknowledge the particular challenges that the NEDs face in making a meaningful contribution, for example, limitations on time, access to information and complexity of business. Companies should be required to consider annually the need for a dedicated resource to support the NEDs and should disclose that they have done so in the Annual Report. This is similar to the current provision to consider the need for an internal audit function on an annual basis. Such a 'NED Secretariat' would be dedicated solely to supporting the NEDs in terms of information requirements. This resource would be under the overall responsibility of the company secretary, but it could comprise staff with experience from other parts of the organisation such as the finance function.

It would also be helpful if consideration was given to the merits of requiring disclosure as to what independent professional advice was actually obtained. It may be appropriate for the board to include a statement about the types of circumstances in which it would be normally expected for the NEDs to seek this sort of advice. This could also apply to the board committees, for example, there is a provision in the Smith guidance on audit committees that the committee should take independent advice when necessary.

Taken as a whole, we believe that these recommendations could enhance the quality of information supplied to the board with a consequent beneficial impact on the level of discussion and debate.

The code response in detail (continued)

Asking the right questions

It has been suggested that the failure of boards to 'ask the right questions' has been a major contributor of recent corporate difficulties. For example, the purchase of ABN Amro by Royal Bank of Scotland has been acknowledged by the former chairman, Sir Tom McKillop, as a mistake. However, in defence, he argued that the board had 18 meetings to discuss the proposed takeover and that there was widespread support for it. But what the external observer cannot know is the quality of the debate at those 18 meetings. Did anybody play devil's advocate to ask the most awkward questions? Did the NEDs fully understand what was being proposed so that they could ask the right questions?

In a non-banking context, the demise of Woolworths has been well documented. What is apparent though is that it had strategic and financial weaknesses for many years. It was therefore unsurprising that the downturn delivered the 'killer blow'. The question that should be asked here is therefore whether the directors were themselves asking the right questions – should the board have encouraged a friendly takeover to preserve the brand and the valuable parts of the business? In hindsight, it appears that Woolworths struggled on for too long until it was too late to retrieve the situation.

The problem here though is that trying to encourage directors to ask the right questions is not easy to encapsulate within a code of best practice. The code does state that directors should constructively challenge and help develop proposals on strategy. However, the recent Turner Review may give some pointers in that it emphasises that it is 'vital to achieve external challenge to conventional wisdom assumptions'. The review recommends that banks should consider devices such as inviting external academics to review the conclusions of analysis and to present deliberately counter conventional wisdom views. The code could therefore make a similar recommendation for external challenge although stopping short of being too specific. CIMA is exploring how boards can develop mechanisms for inviting constructive challenge at a business breakfast in July 2009.

Remuneration

Remuneration has been one of the most debated and contentious aspects of the current crisis. Again, the current code is comprehensive in its coverage of this subject although we would recommend that there should be more explicit mention of the need to base rewards on long-term sustainable performance.

In terms of good practice in remuneration reporting, CIMA, in conjunction with PwC and Radley Yeldar, have undertaken and prepared a report in their *Report Leadership* series, which is recommended for review and can be accessed at **www.reportleadership.com/newsletter/brochures**

Finally, it is suggested that the remuneration committee's responsibilities are extended to the overall remuneration framework for an organisation and its links to its strategic and operational risks. This would give the committee a clear sight of remuneration below board level – particularly crucial in organisations where employees are paid more than board members. It would also give the committee the opportunity to review the overall profile of salaries throughout the organisation. While we would not advocate setting limits on salary multiples, we believe that the remuneration committee should have the responsibility to consider whether the salary profile is acceptable from an ethical perspective. Companies should also explain how and why their remuneration structures are consistent with their strategic aims and objectives. This issue is considered in more detail in the *Report Leadership* publication on executive remuneration referred to above.

The shareholder dimension

The current corporate governance model requires shareholders to hold boards accountable. However, as Ira Millstein has pointed out in the 2008 Charkham memorial lecture, the patterns of corporate ownership are changing rapidly. There is now a different landscape of institutional shareholders beyond the traditional pension funds and mutual funds – such as sovereign wealth funds, hedge funds, private equity funds and the state. Each of these owners may have different investment horizons and objectives. So there is a serious challenge to be met here to find ways of encouraging investors to be 'responsible owners'. As highlighted in the recent Treasury Select Committee report, the increasing pattern of dispersed ownership and costs of engaging with companies is resulting in the phenomenon of 'ownerless corporations'. We do not believe that this is an issue that can be solved overnight, but it is crucial that efforts continue in the medium-term to understand the profile of company ownership and how owners can play an effective role in enhancing board effectiveness.

Concluding remarks

While no one disputes that it is imperative to learn from the crisis in the financial sector, it is equally vital that policy makers do not respond with ill-considered measures which are then misapplied to other sectors with an adverse impact on governance and the long-term prosperity of the UK.

The emphasis needs to be on an evidence based approach, rooted in robust research to identify whether or not there have been significant corporate governance failings beyond the financial sector with its unique problems. It is also crucial to examine closely the conclusions of the Walker Review to ensure that we apply only those recommendations that are relevant to the corporate sector generally.

CIMA believes that the FRC has a potent role to play in championing governance. A key part of this should be to commission and disseminate research on what constitutes good governance and to undertake considered investigations into instances of major failings. Active discussion should be encouraged as to how the role of the FRC should be defined in this regard and what resources or new powers would be required to support it.

A second strand of worthwhile research would focus on the effectiveness of the current UK corporate governance model and whether there are alternative models that should be explored over the medium to long-term. The scale of the financial crisis is such that searching questions are understandably being asked about the future shape of capitalism. At this stage, it is not possible to answer such broad questions.

Even so, there is scope for swift action in terms of practical lessons to be gained from case studies. We have recommended a number of possible options in this paper for further consideration by the FRC and the wider financial community.

References

Enterprise governance – getting the balance right (IFAC/CIMA, 2004)

Report leadership – tomorrow's reporting today (CIMA/PricewaterhouseCoopers/Radley Yeldar/Tomkins, 2006)

Report leadership – executive remuneration (CIMA/PricewaterhouseCoopers/Radley Yeldar, 2007)

Report leadership – online reporting (CIMA/PricewaterhouseCoopers/Radley Yeldar, 2007)

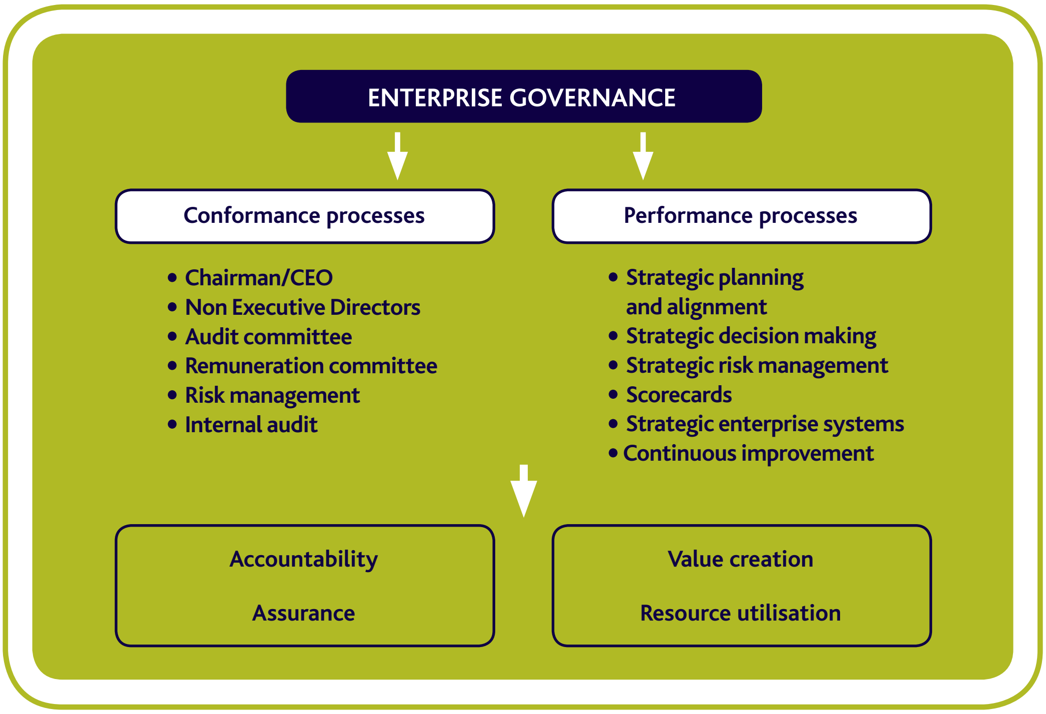
CIMA Strategic Scorecard™ – boards engaging in strategy (CIMA, 2007)

Appendices

Appendix 1

The enterprise governance framework

In 2002, the Professional Accountants in Business Committee (PAIB) was asked by the International Federation of Accountants (IFAC) to explore the emerging concept of enterprise governance. A particular focus of the project was to consider why corporate governance often fails in companies and, more importantly, what must be done to ensure that things go right. The enterprise governance framework is illustrated below.



The key point to note about the framework is that enterprise governance encapsulates two dimensions of corporate governance processes i.e conformance and performance that need to be kept in balance.

The conformance dimension covers issues such as board structures and roles as well as executive remuneration. Codes and/or standards can generally address this dimension with compliance being subject to assurance/audit.

The performance dimension centres on strategy and value creation. The focus is on helping the board to make strategic decisions, understand its appetite for risk and the key drivers of performance. This dimension does not lend itself easily to a regime of standards and audit. Instead, it is desirable to develop a range of best practice tools and techniques that can be applied intelligently within different types of organisation.

The research that was undertaken as part of the enterprise governance project involved a series of case studies covering ten countries and ten market sectors. The case studies considered both corporate governance and strategic issues. Another key feature of the work was that both successes and failures were considered.

The context of the time was the spate of high-profile corporate failures in 2001–03, the most well-known being Enron and WorldCom. There were other cases such as Marconi in the UK where although the company did not collapse, significant amounts of shareholder value were lost and substantial changes were required to put the company back on the road to recovery. Such debacles shook confidence in the corporate world and much effort was put into understanding how such failures could be prevented in the future.

IFAC/CIMA published its findings in early 2004 – *Enterprise governance: getting the balance right*. The key message was that companies needed to balance both conformance and performance. There was some concern at the time that the main response to the crisis was an excessive tightening of corporate governance codes and legislation – best exemplified by the passing of the Sarbanes-Oxley Act in 2002. The enterprise governance report argued that while compliance was important, it was also essential that companies did not lose sight of the need to ensure long-term strategic performance if they were to achieve long-term success. In other words, good corporate governance might help to prevent failure, but on its own could not create success.

The key learnings
Preventing failure
Corporate governance – key issues

The 2004 enterprise governance case studies highlighted the following four factors that were instrumental in preventing failure:

- culture and tone at the top – in particular, the need to ensure that the messages provided by senior management reinforced appropriate behaviours in practice. In the case of Enron, for example, although the board emphasised ethics and codes of conduct, employees quickly learned that these were not reinforced and what really mattered was rapid growth and bottom-line earnings
- the chief executive – there were numerous examples of chief executives who exercised unfettered power and who pursued ambitious strategies with little restraint
- we also found cases where the board of directors proved inadequate and failed to provide sufficient oversight of the chief executive and the management team
- weak internal controls.

Achieving success
Strategy – key issues

The study also considered strategic issues and the following were instrumental in achieving success:

- choice and clarity of strategy
- strategy execution
- responsiveness to abrupt changes, fast moving market conditions, information flows
- competency in mergers and acquisitions
- effective risk management.

As a consequence of the study, we identified key issues for more detailed research:

- strategic oversight and board performance
- risk management.

Part of CIMA's subsequent work included the development of the CIMA Strategic Scorecard™ as a means of helping boards to oversee strategy more effectively. Brief background on this is provided in Appendix 2.

Appendices (continued)

Appendix 2

The CIMA Strategic Scorecard™ – how boards can engage in strategy

An effective board of directors has the potential to be a considerable asset for an organisation. Board members can bring a wealth of experience and knowledge to bear on ensuring that the organisation is well led and on helping to shape its future strategic direction.

However, cases studies undertaken as part of the IFAC/CIMA enterprise governance project indicated that a key requirement for boards was to be able to oversee strategy effectively. But it can be difficult for boards to engage in strategy effectively due to:

- lack of time and crowded agendas
- information overload
- lack of robust processes at board level for dealing with strategy.

CIMA developed the CIMA Strategic Scorecard™ to address these difficulties. This gives the board of any organisation a simple, but effective process that helps it to focus on the key strategic issues and – most importantly – to ask the right questions. This means that the board can work constructively with management to ensure the future success of the organisation.

What makes the scorecard unique is that it pulls together all aspects of the organisation's strategy in a single document as it:

- summarises the key aspects of the strategic position to ensure that the board is aware of changing economic and other factors
- identifies the major strategic options that could have a material impact on the strategic direction of the organisation and helps the board to determine which options will be developed further and implemented
- charts for the board the significant steps or milestones in relation to the chosen strategic plans to be achieved in the coming period and then tracks performance against these
- highlights the risks facing the board in its strategic endeavours and moves these into manageable opportunities or mitigation plans.

The CIMA Strategic Scorecard™ in outline

The CIMA Strategic Scorecard™ is shown below with its four dimensions.

For each dimension of the scorecard, the board is presented with summarised high-level information. By giving the board the 'big picture', directors can offer constructive, informed input; in return, they receive assurance in relation to the organisation's strategic position and progress. In effect, the scorecard provides an integrated and dynamic framework that focuses on the major strategic issues facing the organisation and ensures that the strategy is discussed at board level on a regular basis.

CIMA has also found that the scorecard offers benefits to the organisation's management. The discipline of having to prepare and update the scorecard helps management to keep its focus on the key strategic issues and to refine its proposals prior to exposure to the board.

Appendix 3

Report Leadership Group's response to the FSA about the future of Corporate Governance in the UK banking sector

Sir David Walker
The Financial Services Authority
25 The North Colonnade
Canary Wharf
London E14 5HS

21 May 2009

Dear Sir David

We write on behalf of the Report Leadership Group (RLG), in response to your request for views about the future of corporate governance in the UK Banking sector. The RLG was formed a few years ago to promote new and more progressive thinking in corporate reporting. Given the knowledge and interest of the group, our letter is restricted to the role of reporting in effective governance, an area to which, we believe, insufficient time and attention has been devoted over the past decade. In particular, we would highlight the fact that the quality and scope of information available is a critical determinant of:

- how well a company is managed by its executive team
- whether non executive directors are in a position to exercise effective governance
- a company's ability to communicate externally on its operating environment, its strategy and performance and the key strategic risks and opportunities it faces
- whether shareholders are in a position to exercise effective oversight and to engage with the company on the issues that matter.

Accordingly, we believe that it is essential for the issues of governance and reporting to be considered in parallel. Importantly reporting can be used as an effective catalyst for changing behaviours without the need for a lot of detailed regulations. For this reason and others explained in this letter, we believe a key recommendation coming out of the Walker and FRC Combined Code reviews should be for a fundamental review of the reporting model, with the objective of understanding how it can be enhanced to support more effective management, governance and shareholder oversight.

1. The short comings of the current reporting model

The Group's motivation for coming together a few years ago was largely based on the view that the current reporting model was too dependent on financial aspects of reporting, which in itself was becoming technically complex, inaccessible to all but the technically elite and increasingly remote from normal day to day business activity. With many annual reports now running to hundreds of pages, identifying the important and the material from the routine and unimportant has become largely impossible.

Furthermore, other critical aspects of reporting, such as the market context, strategy, explanation of the dynamics of the business model, risk and remuneration, while being elements of the UK reporting model have not been focused on with the same degree of rigour as for financial reporting. As a result, the quality of reporting remains very variable today. In addition, there has been a failure to recognise that it is the interaction and linkage between these critical elements which in large part explain whether a company is well managed, whether it can provide evidence that effective governance has occurred and whether shareholders have been put in a position to have a meaningful dialogue with executive management.

Appendices (continued)

Rather than reporting being a process of effective communication of the factors that matter in assessing the long-term sustainability of a business, it has become largely a compliance exercise focused on short-term financial performance. In short, it is a process which commands significant time and resources from companies and auditors but is too often sub-optimal for the following reasons:

- The reporting model is dominated by short-term financial performance and a compliance mind set. As a consequence regulated reporting is not an effective communications tool.
- Investor relations has become a parallel process aimed at explaining what is considered important.
- Boards of directors feel remote and excluded from the reporting model because of its complexity and it does not help support or illuminate the presence of effective governance.
- Auditors spend a disproportionate amount of time on technical reporting issues.
- Shareholders and investors believe it is sub-optimal from both an analysis and oversight perspective.

Taken as a whole, this is a worrying picture for those working to ensure that the governance and oversight provided by NEDs and shareholders is efficient and effective.

2. Information symmetry

Through our work, we have become aware of the linkage that exists between the quality of internal information used to run a business and the organisation's ability to report coherently to the outside world. If a company has a clear strategy, which is consistent with the environment in which it operates, an understanding of its risks and KPIs, as examples, it is better placed to present this information in a convincing fashion to shareholders.

We believe that this alignment and symmetry should extend to the information set that is routinely used in the boardroom. While we recognise that it is not the role of the board actually to run the company, but rather to oversee and guide the executive management, it should be in a position to understand the direction of travel, the business model and the key risks and relationships on which the business depends. Performance information on which the board relies to carry out its role should not be restricted to financial information and should provide insights into the health of the key drivers of value and long-term commercial success.

As discussed below, we believe consideration should be given to introducing a recommendation for boards to disclose how they spend their time in fulfilling their role and this could also include making reference to the scope and nature of the information with which the board is routinely provided.

3. Connectivity

One of the strong themes emanating from the RLG work is the ability to show that the thinking and actions inside a business are truly joined up and aligned. In this regard, we would make two observations which the Committee may wish to consider in making its recommendations about the future direction of governance in the banking sector.

The first is the need for boards to be able to explain what actions and processes routinely occur to help the board satisfy itself that its views and thinking are truly connected to the rest of the organisation, in the information it receives and the subsequent decisions made and actions taken. The key questions that non executives need to be asking are 'What is happening on the ground?' and 'What do our key stakeholders think?'

Secondly, we believe it is critical for the Committee to consider, in the context of reporting, how the interaction between the main board and its separate sub committees operates, so as to avoid each element being treated as if it is a separate silo of activity. It is worth reflecting on the fact that the scope of work by audit committees has grown, remuneration committees' remit is being extended and the potential introduction of risk committees, without appropriate thought being given to connections between these committees and the board, may only exacerbate a sense of fragmentation which needs to be avoided.

4. Current governance reporting – Leveraging what's valuable

It has been said by some shareholders that the last place to look for any shortcomings in governance is in the governance report. In part, this reflects the fact that many companies take a largely compliance approach to governance reporting. While there are some good examples of innovative thinking, this is not the norm. Furthermore, we should recognise that governance reporting has evolved over a number of years in the UK and that some aspects of reporting, while informative in the past, now deliver little real value.

PricewaterhouseCoopers produces an annual publication highlighting best practice in corporate governance reporting and it is clear from this that a number of companies have thought carefully about the information they disclose. We believe that there are some specific areas of reporting which are particularly important and valuable to investors and where more focus should therefore be given. In summary, these are as follows:

4.1 The board agenda

It has become best practice in the reporting of some sub-committee activity to explain what topics and issues the sub-committee has been dealing with over the year. There is a strong argument that the board should explain in broad terms the scope and nature of the issues that it has dealt with over the year. It could provide an opportunity to explain how much of directors' time is now devoted to compliance related activity.

4.2 Board balance

In the context of all that has been discussed about the banking and financial services skills, experience and knowledge of NEDs that serve on the boards of banks or financial services companies, it would make sense for the profiles of NEDs contained in annual reports to make specific reference to the suitability of their roles and the contribution that they can make, rather than allowing readers merely to infer this from the biographical information.

4.3 Board reporting

The ability of a board to function effectively is largely determined by the scope, quality and timeliness of the information they receive about the business, particularly its progress towards agreed objectives and targets. In reality, this 'top slice' of management information (both financial and non financial) should provide the substance of the company's external reporting.

4.4 Performance evaluation

A clear explanation of the processes that the board has been through to obtain independent feedback on the overall board performance, including discussion of the outcomes of the evaluation and the actions the board intends to take as a result.

4.5 Internal control and risk management

The increased focus on risk management and risk taking would argue for risk reporting to become more prominent in the future. Risk, both strategic and operational pervades all aspects of business activity and this should be reflected in the way boards talk about risk and how they explain the risk mitigation strategies in place.

4.6 Remuneration

The importance of remuneration and incentive structures to the risk appetite of an organisation has been a major learning from the credit crunch. Executive remuneration is a particular area of reporting which has been the specific focus of the Report Leadership Group. We attach to this letter the best practice remuneration report which was developed with the assistance of shareholders and some remuneration committee chairman. The main focus of the report was to create a communication document that explained the real dynamic of the remuneration policies rather than a sterile compliance document. We believe the report achieves a number of critical elements as follows:

- Articulation of the organisation's overall remuneration strategy, policies and principles and the purpose behind each element of pay
- Explanation of how strategic aims are reflected in executive reward
- Detail of the levers used to align executive rewards with the interests of shareholders
- Explanation of how underperformance will affect executive rewards
- Prominent display of the main elements of pay and how they are calculated.

While the model report was developed before the latest remuneration guidelines issued by the FSA we do believe it provides a sound platform for organisations wishing to enhance their transparency on this important area.

5. Making visible indicators of effective governance

In determining the presence of effective governance, we must go beyond the compliance narrative in governance reports and focus on the tell-tale signs of whether good governance is working. One sign is a company's overall commitment to transparency and its ability to present a joined-up picture of the activities which are critical to corporate success. This joined-up picture is achieved by very few companies today, in part because the piece-meal evolution of today's reporting model works against the creation of a logical explanation of a business's performance and its sustainability. However, through our work we believe there are some critical components which should be focused on as we consider how the impact of good governance can be better exposed.

In particular, we would encourage the Committee to focus on a company's ability to:

- Explain its strategy and provide evidence that it is grounded in a real understanding of the market(s) in which it operates and the factors that will impact it across the economic cycle
- Explain the dynamic of the business model and the key risks and relationships to which it is exposed
- Articulate its risk appetite and how this is reinforced by the tone from the top, the cultures and behaviours of the organisation and the structure of remuneration and incentive schemes.

6. Development of corporate reporting and the promotion of best practice

In conclusion, we hope that the content of this letter has reinforced the importance of reporting to the governance agenda for the banking sector, and potentially wider market application, given that the two aspects of business activity are so critically intertwined. In particular, we would encourage the Committee to consider the need for a fundamental rethink of the whole corporate reporting model, to ensure it remains relevant and accessible to NEDs and shareholders alike. In this regard, we believe serious thought needs to be given to who should be responsible for the development of broader corporate reporting, as we would question whether this is a natural or desired role for the IASB. Furthermore, we would encourage a change in the stance of regulators to more actively promote those aspects of best practice reporting which provide evidence of good management and good corporate governance.

Report Leadership Group

Charles Tilley,
Chief Executive,
Chartered Institute of
Management Accountants

David Phillips,
Senior Corporate
Reporting Partner,
PricewaterhouseCoopers LLP

Clive Bidwell,
Head of Corporate Reporting,
Radley Yeldar

978-1-85971-620-5 (PDF)

May 2009

Chartered Institute of
Management Accountants
26 Chapter Street
London SW1P 4NP
United Kingdom

T. +44(0)20 8849 2244
F. +44(0)20 8849 2460
E. research@cimaglobal.com
www.cimaglobal.com

CIMA voted one of the
UK's strongest B2B brands

TE034V0509