

Armstrong Bonham Carter's response to The Financial Reporting Council's call for evidence
in its review of the Effectiveness of the Combined Code March 2009

Armstrong Bonham Carter (ABC) is delighted to contribute to the Financial Reporting Council's (FRC) review of the Combined Code of Corporate Governance.

ABC is a specialist consultancy which advises chairmen on how to improve the effectiveness of their Boards. ABC has canvassed the opinions of its panel of Advisers all of whom have significant experience of company Boards and has also drawn on its own research into the effectiveness of Boards (which was published in December 2007) and experience of managing Board reviews.

The FRC have asked for views on both content of the Combined Code on Corporate Governance (the Code) and the way it has been applied by companies and enforced by investors using the comply or explain mechanism. In particular the FRC has asked for comments on the following:

1. Which parts of the Code have worked well? Do any of them need further reinforcement?
2. Have any parts of the Code inadvertently reduced the effectiveness of the Board?
3. Are there any aspects of good governance practice not currently addressed by the Code or its related guidance that should be addressed?
4. Is the 'comply or explain' mechanism operating effectively and, if not, how might its operations be improved? Views are invited on the usefulness of the company disclosures and the quantity and quality of engagement by investors.
5. The composition and effectiveness of the Board as a whole.
6. The respective roles of the chairman, the executive leadership of the company and the non-executive directors.
7. The Board's role in relation to risk management.
8. The role of the remuneration committee.
9. The quality of support and information available to the Board and its committees.
10. The contact and effectiveness of the Section 2 of the Code, which is addressed to institutional shareholders and encourages them to enter into a dialogue with companies based on a mutual understanding of objectives and makes considered use of their votes.

ABC has commented on each main and supporting principle of the Code in the attached worksheet. ABC's comments on those areas requiring improvement are laid out below.

1. Which parts of the Combined Code have worked well? Do any of them need further reinforcement?

ABC would agree with Sir Christopher Hogg's comment in his recent speech to the ICSA that the Code is not responsible for the failures of corporate governance that have occurred since the onset of the 'Credit Crunch'. After all, the Code is clear that a Board must be entrepreneurial in taking on risk to ensure their company is successful. Indeed, the Code has made the duties and workings of a Board more transparent and has made it much clearer who is accountable for what duty. But the improvement in transparency of exactly what a Board does is still somewhat limited by the continued generally high level of opacity that surrounds the Boards' activities. This in turn limits the improvement in accountability.

1.1: Definition of Effectiveness

Under principle A.1, it is made clear that every company needs to have an effective Board and the chairman is responsible for making this happen (A2 supporting principle). Yet the Code does not define this and in ABC's experience, there is no clear universally adopted definition of an effective Board.

In ABC's view, an effective Board will decide a clear aim for the organisation which will define the scope of success that the Board wants to achieve and the timeframe in which to achieve this. This should then be followed by a comprehensive appreciation to test the feasibility of the aim and lay out the various options of achieving the aim. One of these options will then be chosen as the strategy. Subsequently, the strategy should then be broken down into annual plans and reconciled with the current budgets in order to test the likelihood of success. Clear measures of success should be defined for the aim and each annual plan.

From the strategy and annual plans, specific plans should then be drawn up for the recruitment of the necessary talent at Board level (both executive and non-executive directors), and senior management to ensure the aim is achieved. Equivalent plans should be developed for the provision of sufficient financial and operational resources.

Following this, there should be an effective communications strategy from which both directors and shareholders should know whether the employees are aware of the aim, strategy and plan and what each mean for them individually and whether they support them.

Finally, there needs to be put in place performance measurement and risk management systems to monitor the success of the implementation of the plans, the assumptions underlying the strategy and to know whether they remain valid and

that there is a process of identifying and mitigating risks to the strategy and organisation.

ABC has received many comments from members of numerous Boards suggesting the aforementioned is completely understood by everyone and is assumed to have been carried out. However, in ABC's experience, Boards are prone to be less rigorous places driven by the need to be supportive of the CEO and the executive team, and wishing to avoid being 'held hostages to fortune' by announcing any business targets. Yet, with the lack of a clear definition of Board effectiveness, the majority of Boards still deem themselves to be effective every year according to their Annual Reports.

So without this definition and with the current and somewhat limited information provided by Boards (particularly the lack of a precise aim and targets), it is not possible for anyone outside of the Board to be able to tell whether it is effective or not or contest that frequent assertion that they are. Indeed, investors generally have to wait until the Boards deliver the announced strategy and plan, by which time it may be too late or at least investors are unclear whether any proclaimed success has indeed been down to the Board's actions.

1.2 Consequences of providing greater clarity of aim, strategy and plans on Board composition.

By providing greater clarity on the aim, strategy and plan this will make it easier to assess the skills and experience needed on the Board to achieve them. But it is evident from ABC's experience that even those directors who seemingly have the perfect match of appropriate skills and experience, that this does not, inevitably, result in them becoming effective as an executive or non executive director. Behaviour is also important. Thus when NOMCOMs consider Board composition, they should also assess director performance (both what and how directors have contributed).

1.3 Time spent by NEDs in exercising their duties

Some greater guidance would also be useful over the amount of time spent by the NEDs executing their duties, as much of the debate on the Banks' governance has revolved around allegations that the NEDs spent insufficient time in executing their role. Yet it is hard to be prescriptive. Perhaps it would help to suggest an amount of time spent visiting the company each year in addition to Board and Board committee meetings, to quell this debate.

1.4 Better key performance indicators

On the information Boards receive, it is clear from ABC's experience that NEDs feel there is no shortage of data and are often redefining their requirements. Yet ABC feels KPIs could be more clearly defined as to those monitoring the assumptions on which the strategy and annual plans depend, including the measures of success. Currently, most annual reports mainly quote lagging indicators such financial KPIs, thus leading to an overall impression that Boards may not receive appropriate information, or at least are being otiose over what they receive and do not feel it necessary to share it with their shareholders.

1.5 Improving annual Board performance reviews

On Board reviews, there is little evidence to support whether Boards have been rigorous in these annual exercises. With the default position of Boards being that they are effective until clearly proven otherwise and with no clear definition of Board effectiveness, reviews tend to be introspective exercises focused mainly on Board processes. Anecdotally, ABC has heard numerous comments as to how internally managed Board reviews over time tend to become stale processes.

Now there is a more experienced body of independent Board performance reviewers, there exists an opportunity for Boards to benchmark themselves to test whether they are as effective as they consider themselves to be. Therefore, I believe there is a case to make an external evaluation of a Board a requirement, rather than an option. Certainly, a periodic externally managed Board review would also demonstrate the efforts Boards were making to be more accountable and transparent.

1.6 Improvements to the formulation of remuneration policy

Remuneration policy has lost sight of the requirement to pay 'no more than necessary'. The practice to pay salary increases to match above median pay scales is only justifiable if the executive is an above median performer, but not on the promise or assumption that he or she will become one.

With a lack of clarity over the corporate aim, it is also hard to discern whether the executive team is being rewarded for achieving this. Indeed most incentive targets have been split between a business plan, one (such as an earnings target) and a shareholder interest one (a relative total shareholder return target). There is an inherent risk with the latter target that behaviours and activities unconnected to the aim, strategy and plan are, in fact, being encouraged.

Remuneration policy should be simplified to recruit, retain, and motivate executives with the appropriate skills and experience for the task of achieving the aim. Rewards should then be in place for executives for achieving the business plans, the strategy and thereby the aim. The Board should be required to demonstrate to shareholders

why they believe achieving these plans, strategy and aim should create value for the shareholders. Furthermore, all executives should be required to hold a multiple of salary in shares to demonstrate how they share a common interest with shareholders.

The remuneration policy should then be subject to a binding vote and not an advisory one.

1.7 Improvements to risk management systems

Risk systems have been described in annual reports largely via risk registers. They have identified the 'known unknowns' as Donald Rumsfeld described them. Relatively little information is generally provided on how the risk management process is expected to operate or has worked towards identifying risks that are impacting the organisation and how their effects are to be mitigated or have been mitigated. So when Donald Rumsfeld's 'unknown unknowns' occurred, most risk management systems have been sorely tested and the consensus amongst investors seems to suggest these systems have failed.

Risk management systems should be subject to more benchmarking by independent agents, including internal audit teams which would ensure the spread of best practice and hopefully raise the standard of all these systems.

Companies should also be required to report on how these systems have worked in practice and what improvements have been made, if any, as a consequence to the identification and mitigation of risks.

1.8 Shareholder Engagement

Most companies tend to obfuscate over what their aim is, either by using woolly terminology or confusing things with a multiplicity of aims, missions, visions, objectives, and priorities. This is further compounded by a reluctance to announce targets, which in turn, makes it very hard for shareholders to have meaningful and mutual understanding of objectives.

In the absence of any measures of success, shareholders are then forced to rely on the sell side community of the stock market to prescribe measures of success which tend to be short term, as the analysts themselves have no idea whether the companies want to do medium to longer term.

Companies profess that they need to meet the requirements of all shareholders, both long and short term, which forces them to issue vague hints on what is the aim. Indeed, companies have commented that when they asked their shareholders what they want, they do not get a consensus of opinion over what the aim should be on which they could act.

This should not be surprising, as shareholders may not have the skills, experience, time or willingness to determine what they require from each of their investments. Indeed, in the case of institutional shareholders, their skills are of asset and stock selection not business management. Institutional shareholders feel that is what they employ the Boards to do. They would prefer to manage with hindsight and spend the majority of their time on their clients' investments rather than focussing on particular issues of one of their individual investments.

Nevertheless, if the currently expressed view that shareholders should do more to engage with the Boards of their investments is upheld, then both sides will be required to input more. This can be done by raising the standards of democracy in listed companies. Just as politicians are required to deal with an electorate, who do not necessarily express what they want clearly or have realistic expectations, the politicians nevertheless publish manifestos filled with commitments. So, should listed companies state clearly what they intend to do over the next three or five years, detailing the measures of success and the strategy and plans to achieve it and the rewards for the employees and the executive team for achieving success? This does not have to compromise commercial sensitivity, but investors would be able to determine the 'what' and sufficiency of the 'how' to understand the risks and the suitability of the team and resources.

In return, investors should be required to vote in support or against. This would allow the Boards to focus on achieving an aim over a medium or even longer term which is currently only available to private companies. This would improve accountability, transparency and objectivity over Boards' performance and switch focus to the longer term.

2. Have any parts of the Code inadvertently reduced the effectiveness of the Board?

In ABC's view, no part of the Code has reduced the effectiveness of Boards that comply with it.

3. Are there any aspects of good governance practice not currently addressed by the Code or its related guidance that should be?

As per section 1.

4. Is the 'comply or explain' mechanism operating effectively and, if not, how might its operations be improved? Views are invited on the usefulness of the company disclosures and the quantity and quality of engagement by investors.

It very much rests on the quality of explanation which can vary widely. As the Code has been in existence for sufficient time, companies who chose to explain should

now be required to do so, both absolutely and relatively. There is a tendency to simply invoke the special nature of the company which is hardly sufficient.

5. The composition and effectiveness of the Board as a whole.

As per the aforementioned, Board composition should be determined by the need to achieve the aim, strategy and plans within a framework of effective performance measurement and risk management. The skills, experience, amount of time devoted and behaviour of individual directors will determine the overall effectiveness of the Board.

Interestingly the Dutch code of governance does provide a more comprehensive justification of the suitability of the skills and experience of all the members of the Board.

But the current information provided by UK listed companies in terms of its aim, strategy etc., to the boiler plate comments on Board reviews leaves the outsider none the wiser as to the real level of effectiveness of a Board and the suitability of its members.

However, it should still be noted that Boards will always have to take risks and many will take risks which may, for a period, appear to be wrong or even threaten the survival of the company. The Board's effectiveness will then be tested to see if the Board recognises any errors and whether it takes the appropriate action to ensure the company is successful once more. So effectiveness can only be judged over a medium term timeframe unless the company has gone into administration or is in the process of being wound up.

6. The respective roles of the chairman, the executive leadership of the company and the non-executive directors.

In ABC's view, the role of an executive chairman simply places too great a burden of responsibility on to one individual especially if there is no CEO or COO. It does not, inevitably, mean that a particular individual will fail, but as the burden of leadership is heavy and hard there will need to be, at the very least, an up-to-date succession plan.

Otherwise, the job descriptions of a non-executive chairman, CEOs, executives and non executives have, for the most part, been clear and well understood.

7. The Board's role in relation to risk management.

As mentioned above, the reporting on risk management systems have focussed on risk registers with some limited information provided on mitigation plans and how actual risks were managed when they were incurred.

In ABC's experience of Board reviews, scrutiny of risk management systems is often entirely delegated to the Audit Committee. This may be an effective delegation to members of the Board with the right skills and experience, but it does suggest that Boards as a whole may not be devoting sufficient time to risk management.

However, defining sufficient time for risk management is not an easy task.

8. The role of the remuneration committee.

As mentioned in section 1.

9. The quality of support and information available to the Board and its committees.

As mentioned in section 1.

10. The contact and effectiveness of the Section 2 of the Code, which is addressed to institutional shareholders and encourages them to enter into a dialogue with companies based on a mutual understanding of objectives and make considered use of their votes.

As mentioned in 1.