



Independent Audit's response to the FRC Code Consultation

Q2. Do you have any comments on the revised Guidance?

None, other than that our comments on the proposed Code may have consequential impact on the Guidance.

Q3. Do you agree that the proposed methods in Provision 3 are sufficient to achieve meaningful engagement?

We have two concerns about Provision 3. One is that prescribing a method gives the opportunity for companies to comply with or without any meaningful change resulting. Just nominating a designated director, for example, is not enough in itself. It would be more powerful to give the whole Board responsibilities regarding the workforce. There needs to be more clarity on what the Board is expected to achieve through meeting the requirements of this provision, as without this it is difficult for the Board to be held accountable.

The proposed change does not highlight the opportunities afforded by technology. The three options assume that a physical presence/body is needed to enable boards to gather the views of the workforce, when other means of tapping into workforce thinking could be employed eg internal blogging/forums with a degree of editorial review and analysis. Careful management might be required. But the general point is that in 2020 boards should be investigating technology-based means of gathering views, and it should not be presumed that they must rely on representation by an individual or nominated group.

Q5. Do you agree that 20 per cent is 'significant' and that an update should be published no later than six months after the vote?

Yes.

Q6. Do you agree with the removal of the exemption for companies below the FTSE 350 to have an independent board evaluation every three years? If not, please provide information relating to the potential costs and other burdens involved.

We have concerns about the removal of the exemption for smaller companies. Our concerns start with the apparent misunderstanding of the nature of "board evaluation", which is a poorly chosen label for what was originally conceived (as is apparent from the context in which it is used in the Higgs Report and which is, in fact, reflected in the Guidance) as an input to the feedback loop needed for a board's continuous improvement. The pass/fail connotations associated with the term "evaluation" are misleading and unhelpful, as any attempt to use such inputs for the purpose of "rating" the Board will severely diminish, if not destroy, their usefulness for continuous improvement.

Much of a board's work involves making difficult judgements with only limited information about the risks and potential consequences. Almost all external commentators speak of a board's effectiveness in ways that, in practice, equate it to having made good judgements, with "good judgements" being those that either correspond to the commentator's own views or have already been justified by hindsight. Consequently, in the absence of hindsight, a board reviewer could only meaningfully judge whether a board is "effective" by second-guessing the Board's own judgements.

The absurdity of this logic speaks for itself, and consequently it is our practice as "board evaluators" not only to avoid the word "evaluation" so far as possible but also to refrain from giving an opinion



on whether a board is “effective”. Our objective in board review is to help the Board to work better in future, which is in line with the Guidance, and not to pronounce on the quality of its past judgements or predict the quality of its future ones.

We can readily agree that smaller company boards would often benefit from the same type of external input to their continuous improvement feedback loops as do larger ones. While this would, in theory, be beneficial to the boards, as well as commercially satisfactory to a business such as ours, we do not think that removing the exemption would serve a wider good in practice.

The amount of work needed to help a board improve is not related to the size or valuation of the company, and consequently the costs of a good-quality board review do not diminish in inverse proportion to the FTSE ranking. In our experience, smaller companies are prepared to pay for a good quality board review where their circumstances are such that they perceive the opportunity to obtain real value from it. Conversely, they will spend the minimum possible on what they perceive as low-value compliance obligations.

We are therefore concerned that, if “board evaluation” is to become a requirement for smaller companies whose financial resources are necessarily more constrained, it will lead to the widespread use of low-cost solutions whose primary goal is to show compliance with the Code. Such solutions exist already and are very limited in how much they tell a board about itself and how much they can help it to improve – we do not believe their wider use would serve the purposes of boards, shareholders or other stakeholders. It would be preferable to give smaller company boards discretion as to how they pursue continuous improvement, and require enhanced disclosure of their approach to this.

Shareholders already express the desire for enhanced disclosure regarding “board evaluation”. As explained above, the Code should define reasonable, realistic expectations of what might better be called “board review” or even “review of how the board is working”. Effective disclosure, therefore, will show the Board’s attitude to continuous improvement, and it is this which will enable those companies who conduct a more thorough review with a more experienced reviewer to distinguish themselves. In our view, (taking into account the unavoidable fact that some of what comes out of a good board review is necessarily best kept private) good disclosure is the most effective way of enabling an assessment of the quality of the Board’s approach to its self-improvement.

The Guidance should suggest disclosure of the review objectives, its method, how the Board will take forward suggestions, and the experience of the reviewer. On methodology, the Annual Report could, for example, include the number and range of interviewees; whether board and committee papers were reviewed; what was observed, and what type of session was held for feedback. Or it might outline how an entirely different method, such as a workshop-based approach, was the most appropriate way of meeting a board’s continuous improvement objectives at a particular time. The content of questionnaires is proprietary information but disclosure should be sufficient to give an understanding of their objectives, structure and scope.

On taking forward suggestions, the Board could explain the type of discussion it had around the results and suggestions, who has taken these as actions, and whether there will be any follow-up with the reviewer. Subsequent progress should be reported. Disclosure should include the extent and nature of the review firm’s relevant experience underpinning its qualification for the role. The involvement of the review firm in board review or other board advisory work for the company over the last nine years should be disclosed, in addition to the existing requirement for disclosure of other business relationships. Combined with a description of the approach, this will allow the stakeholder to judge its appropriateness.



The Annual Report text should continue to be written by the company, but the reviewer should be required to sign off on what is published regarding the board review – not because the reviewer is giving a formal opinion, but to make sure the review process and outcomes are not misrepresented.

Q7. Do you agree that nine years, as applied to non-executive directors and chairs, is an appropriate time period to be considered independent?

Yes. We are not convinced that years of service is a reliable measure of independence, but if this is to be used as a proxy then nine years is reasonable.

However, we consider that the chairman role is distinct from that of other NEDs, and so they are not independent in the same way. Because the role is so challenging, nine years is too short a period for the total tenure of someone who becomes Chair after a period as a NED. Twelve years would be more appropriate, with a maximum of nine in either separate role.

Q8. Do you agree that it is not necessary to provide for a maximum period of tenure?

Yes – it would be enough for them to be regarded as non-independent for the purpose of the Code. There are many good reasons why someone might stay on a Board for a longer period, and investors can vote them off if they choose to.

Q9. Do you agree that the overall changes proposed in Section 3 of the revised Code will lead to more action to build diversity in the boardroom, in the executive pipeline and in the company as a whole?

Possibly – diversity targets have proved effective – but this does not address the underlying diversity problem, particularly outside the boardroom. Most companies we come into contact with are very aware of diversity in the boardroom – particularly gender diversity – and investors are enforcing this effectively. There is a time lag now in addressing it. The real priority now is to get more women into senior executive roles in order to provide a pipeline of board candidates. To help achieve this might mean encouraging more diverse pools of job candidates and training in unconscious bias to avoid the problem being perpetuated by people picking others like themselves. However, this is a complex problem which the FRC might more readily approach outside the Code.

Q10. Do you agree with extending the Hampton-Alexander recommendation beyond the FTSE 350? If not, please provide information relating to the potential costs and other burdens involved.

Yes – the reasons for promoting boardroom diversity apply just as much to small companies. Furthermore, it is important to increase the size of the pool (across all diversity aspects) so the more that potential directors can be given experience in smaller companies the better. However, it should be recognised that they often have small boards so more time is needed to allow for change.

Q14. Do you agree with the wider remit for the remuneration committee and what are your views on the most effective way to discharge this new responsibility, and how might this operate in practice?

It is a good idea to state in the Code that RemCos should oversee remuneration and workforce policies and practices. Although this is beginning to extend the Board's reach into areas of management decision-making, it is not doing this any more than is already the case in other areas eg controls over reporting, risk management effectiveness, conduct policies, etc.



Ultimately, it is the Board's responsibility to oversee the way management are running the business – and how people are rewarded and motivated is a key aspect of this. It will also help ensure that RemCos can review executive rewards in the context of wider employee remuneration.

However, onerous reporting requirements on pay for a greater number of people should be avoided at all costs. Reporting requirements are already an industry in themselves and the FRC should consider ways in which they can be streamlined rather than adding continually to the burden.

Any such responsibility should normally sit with the RemCo. RemCo is the logical place as it will already be familiar with performance management practices and motivation issues and will be working closely with HR.

Q16. Do you think the changes proposed will give meaningful impetus to boards in exercising discretion?

No. The Code should even more clearly strengthen the concept of discretion as a positive thing when used appropriately, but the change needs also to come from the investor side – without this, boards and RemCos will still be constrained in what they can achieve.