



FINANCIAL REPORTING COUNCIL

REVIEW OF THE 2003 COMBINED CODE

THE FINDINGS OF THE REVIEW

JANUARY 2006

EXECUTIVE SUMMARY

1. During 2005 most listed companies reported for the first time on how they have applied the 2003 Combined Code. The FRC has conducted a review of the progress made by companies and investors in implementing the Code, and whether any practical issues have emerged. It has considered the views of respondents to a consultation exercise held between July and October 2005 and assessed the available data on compliance with the Code.
2. Overall the response from stakeholders has been positive. The 2003 Combined Code appears to be bedding down well and having a positive impact and, while there is an expectation of further improvement, there is no demand for significant changes to be made at this stage.
3. It was the overwhelming view of respondents to the consultation that there has been an improvement in the quality of corporate governance among listed companies since the introduction of the revised Combined Code. Most companies are properly adopting the 'comply or explain' approach, and where comparative data is available it shows that an increasing number of companies are choosing to apply the majority of Code provisions.
4. Both companies and investors report that the dialogue between boards and their main shareholders is more constructive than it had been a couple of years ago. This is to be welcomed as the success of the 'comply or explain' approach to corporate governance depends on constructive engagement between boards and investors.
5. While most investors appear willing to accept explanations where the company has a good case, the review has identified a continuing concern that the Combined Code is viewed in some quarters as a rigid set of rules. This is not how the Code should be applied. The principle of 'comply or explain' – for which the review found strong support - recognises that one size does not fit all, and that there will be circumstances where it is in the interests of the company and its owners to adopt practices that differ from those set out in the provisions of the Code. In those circumstances companies can comply with their obligations under the Listing Rules by explaining why they have taken that course of action. For 'comply or explain' to be effective companies need to provide meaningful explanations and investors need to consider them on their merits.

6. Investors consider that the overall quality of disclosure in annual reports has improved noticeably over the last couple of years, although they see scope for corporate governance statements to become more informative still, for example when describing how the company has applied the principles of the Code. The FRC would encourage companies to consider how they can best make use of the opportunity provided by the corporate governance statement in their annual reports to demonstrate how they are ensuring good governance.

7. In light of the progress that has been made since 2003, respondents to the consultation exercise considered that major changes to the Code were neither necessary nor appropriate. The FRC agrees with this view.

8. However, the review has identified two potential changes for which there would appear to be substantial support:

- amending the existing provision relating to the composition of remuneration committees to enable the chairman to sit on the committee where he or she was considered independent on appointment; and
- amending the existing provisions relating to the AGM to provide shareholders voting by proxy with the option of withholding their vote, and to encourage companies to publish details of proxies lodged on resolutions that were voted on a show of hands, as recommended by the Shareholder Voting Working Group.

9. These proposals are set out in more detail in a separate consultation document, available at: www.frc.org.uk/corporate/combinedcode.cfm. Comments are invited by 21 April 2006. In addition to the two changes identified in the previous paragraph, the FRC is consulting on some minor amendments to clarify existing requirements. If any changes are made to the Code, the intention is that they would apply to financial years beginning on or after 1 November 2006.

10. The FRC will continue to monitor the way that the Combined Code is being implemented by companies, investors and their advisers and the impact that it is having on them and on standards of corporate governance in the UK. In particular, the FRC will keep under review issues that have been identified as part of this review, including:

- the cumulative burden of new compliance requirements on listed companies, in particular on smaller companies, and on the impact on the role of the board. As the Combined Code makes clear, corporate governance should contribute to, not distract from, boards' ability to provide strong entrepreneurial leadership. This needs to be taken into account when considering how the Code is being implemented and the impact that it is having; and
- the ability of listed companies to recruit non-executive directors. The review has found no clear evidence to support the perception that there is a generic problem, and data shows that the total number of non-executive directors serving on the boards of listed companies has increased in the last twelve months.

11. It remains possible that further changes to the Combined Code may be required as a result of new EU requirements under the revised 4th and 8th Company Law Directives or changes to UK law introduced in the Company Law Reform Bill. The FRC will also need to consider the implications of the Government's decision to remove the statutory requirement for quoted companies to publish an Operating and Financial Review and the outcomes of the DTI's current consultation on the statutory Business Review. If further changes to the Code are proposed as a result of any of these developments, there will be full consultation before any action is taken.

THE REVIEW PROCESS

12. A public consultation exercise was held between July and October 2005. Views were invited on any aspect of implementation of the Code, but in particular on the following questions:

- has the Code begun to have an impact on the overall quality of corporate governance in UK listed companies? Are there any areas in which practice has notably improved?
- have companies come up against any practical barriers to implementing the Code?
- how informative are the corporate governance statements in the annual reports, and has there been a change in the overall quality of disclosure?
- where companies are choosing to explain rather than comply with a particular provision, how informative are those explanations and are they being accepted by shareholders?
- has the Code had an impact on the level and quality of dialogue between boards and their shareholders?
- what impact has the Code had on smaller listed companies, in particular those outside the FTSE350?

13. 59 responses were received from listed companies, investors and other stakeholders. A summary of the main issues raised by respondents can be found at www.frc.org.uk/corporate/combinedcode.cfm. This document also contains a list of respondents. Copies of individual responses are available on request from codereview@frc.org.uk.

14. In addition to the public consultation the FRC analysed data on the implementation and impact of the Combined Code that has been published during 2005, and commissioned Manifest to provide data on implementation of the Code among a sample of 370 listed companies outside the FTSE350. The FRC also studied a sample of corporate governance statements in annual reports, and held meetings with representative bodies.

THE IMPLEMENTATION OF THE CODE

15. Overall the response from stakeholders has been positive, and a strong endorsement of the 'comply or explain' approach, although some concerns have emerged. The 2003 Code appears to be bedding down well and having a positive impact, and while there is an expectation of further progress there is no demand for significant changes to be made.

Has the Code begun to have an impact on the overall quality of corporate governance in UK listed companies? Are there any areas in which practice has notably improved?

16. It was the overwhelming view of respondents to the consultation that there has been an improvement in the quality of corporate governance among listed companies since the revised Combined Code came into force. This is consistent with an NAPF survey published in August 2005, which found that 94% of large pension funds believed that corporate governance standards in UK companies were improving¹. A MORI survey of investors carried out for the FRC earlier in 2005 found that 94% of investors had confidence in UK corporate governance and 74% felt it had improved in recent years².

17. Among FTSE350 companies the percentage of companies choosing to follow the provisions of the Code has increased for the majority of provisions for which comparative data is available. No comparative data is available for companies outside the FTSE350, and no data is available on the extent to which explanations offered by companies have been accepted by their shareholders.

18. The response to the provisions relating to the professionalism of the board - for example on induction, training and evaluation - that were added to the Code in 2003 has been broadly positive. A survey published in October 2005³ found that over 70% of company secretaries felt that the Combined Code provisions on board evaluation were workable, although there was a notable difference of opinion between the largest companies and smaller companies. 78% of those surveyed believed that evaluation would improve the effectiveness of the board.

¹ 'Pension Funds' Engagement with Companies 2004', NAPF, August 2005.

² 'Annual Report 2004/05', Financial Reporting Council, June 2005.

³ 'Evaluating the Code: is board performance evaluation working?', Edis -Bates Associates, October 2005.

19. The Higgs and Tyson reports on non-executive directors commented on the potential benefits to companies of greater diversity among non-executive directors. The Female FTSE Report 2005, published in November, found that 78 of the FTSE100 companies had at least one female director on the board and that women held 121 FTSE100 directorships in total⁴. Both of these figures were the highest since data was first collected in 2000. A survey of FTSE 350 companies carried out by Deloitte found that although these companies still tend to recruit primarily from other major listed companies, there is evidence that other sources are being utilised (for example, professional advisers such as lawyers and accountants and directors from private and non-UK companies)⁵. The FRC would encourage companies to consider whether they can broaden the sources from which they seek to recruit new directors.

Have companies come up against any practical barriers to implementing the Code?

20. Some companies stated they had experienced no practical difficulties in applying the Code, in some cases noting that the 'comply or explain' principle had enabled them to put in place governance arrangements that got around any potential difficulties. Others commented on the level of resources needed to implement some provisions of the Code. This was particularly an issue for smaller companies, and was frequently linked to a broader concern about the cumulative impact of regulation and the amount of the board's time spent on compliance rather than strategic issues.

21. The perceived difficulty of recruiting sufficient independent non-executive directors to meet the recommendations in the Code on the minimum level of independent representation on the board was raised by some respondents. These respondents considered that the increased workload expected of non-executive directors and concerns about their potential exposure to liability had made some individuals less willing to serve on boards of listed companies.

22. The review has found no objective evidence that there are systemic difficulties in recruiting non-executive directors. The available data suggests that the total number of non-executive directors has continued to increase both in absolute terms and as a percentage of board members. According to Deloitte⁶ there was an increase of almost 5% in the total number of non-executive directors in FTSE350 companies between 2003/04 and 2004/05, and 96% of the smaller listed companies analysed by Manifest had at least two independent non-executive directors as recommended in the Code. The FRC will continue to monitor the situation.

⁴ 'The Female FTSE Report 2005', Cranfield Centre for Developing Women Business Leaders, November 2005.

⁵ 'Building Confidence: 2005 survey of board structure and policies', Deloitte, 2005

⁶ 'Board structure and non-executive directors' fees', Deloitte, September 2005

23. Some companies reported that they had experienced difficulties in finding suitably qualified candidates willing to serve as the audit committee member with “recent and relevant financial experience”, as recommended by provision C.3.1 of the Code. It was considered that this was in part because candidates were drawing parallels with the statutory requirement in the US for companies to identify a named individual as the ‘financial expert’, which was felt to have increased those individuals’ potential exposure to liability.

24. Some companies are choosing to explain rather than comply with this provision by stating that the audit committee as a whole has the necessary experience. However, the revised 8th Company Law Directive contains a requirement for audit committees to include an individual with “competence in accounting or auditing”. The FRC has drawn companies’ concerns to the attention of the DTI, which will be responsible for implementing the Directive in the UK.

How informative are the corporate governance statements in the annual reports, and has there been a change in the overall quality of disclosure?

25. Investors consider that the overall quality of disclosure in annual reports has improved noticeably over the last couple of years. In its response to the review, one institution commented that “disclosure overall has improved significantly... [and] has therefore already added value, and will continue to do so into the future”.

26. While welcoming these improvements, investors consider that there remains scope for corporate governance statements to be made more informative. In particular they would like to see more information on how the principles of the Combined Code have been applied, and company-specific explanations when the company chooses not to follow the provisions of the Code.

27. Investors and other respondents also commented on what they saw as the ‘boiler-plate’ nature of many disclosures, and said that they would welcome more discursive corporate governance statements which gave a clearer impression of how the company had addressed governance issues during the year. However, some companies were concerned that a more discursive statement might result in criticism from those ratings agencies and institutions that they perceived to take a ‘box-ticking’ approach to assessing corporate governance statements. The FRC would encourage companies to consider how best they might provide investors with the sort of information they find useful, and would also encourage investors to give feedback to companies on this issue.

28. There was no desire for the length of corporate governance statements to increase, and there was a view shared by some investors and companies that statements already tended to be too lengthy. Some respondents suggested that more use might be made of company websites rather than annual reports to provide information on corporate governance practices.

29. As part of the review, views were sought on a proposal from the Audit Quality Forum for the Code to be amended to require companies to disclose the terms of the audit engagement letter on their websites. Responses were divided on the issue, and the FRC does not consider that there was sufficient support to justify further consultation on a possible amendment to the Code. Responses on this issue have been shared with the DTI as the Company Law Reform Bill contains a power that would enable this to be made a statutory requirement if considered appropriate.

Where companies are choosing to explain rather than comply with a particular provision, how informative are those explanations and are they being accepted by shareholders?

30. The review found strong support from companies and investors for retaining the ‘comply or explain’ approach to applying the Combined Code, as it provides flexibility for companies to adopt governance practices that are most appropriate to their particular circumstances.

31. There is currently no data available on the extent to which explanations made by companies are being accepted by shareholders, but most investors that responded to the review reported that they consider explanations on their merits, and many companies confirmed that this was the case in their experience. It is clear that an explanation is more likely to be accepted when it is company-specific and, when appropriate, has been discussed in advance with shareholders.

32. However, some companies continue to be critical of some rating agencies and investors for a perceived ‘box-ticking’ approach to the Code. It also appears that some companies are reluctant to run the perceived risks of explaining and, consequently, may tend to default to compliance regardless of their circumstances.

33. As principle A.1 of the Combined Code makes clear, corporate governance should support, not constrain, the board’s ability to provide entrepreneurial leadership. The test of a company’s governance practices should be whether they have helped to generate shareholder value through improved business performance, not just whether they have increased transparency. While it might be expected in most instances that this would be achieved by following the good practice set out in the provisions of the Code, there may be occasions where an alternative approach is more appropriate.

34. The FRC would encourage all companies to adopt the governance practices that are most appropriate to their particular circumstance. It is recognised that companies will be more comfortable following practices other than those set out in the Code when they are persuaded that shareholders and their advisers are willing in principle to accept explanations. Many investors are already doing so, and it is hoped that the experience of the most recent reporting round will provide some reassurance to companies. In turn, companies cannot assume that any explanation will be acceptable, and should aim to demonstrate to their shareholders that they are applying the principles of the Code through their chosen governance practices.

35. One specific issue that was raised by some companies during the review is the length of tenure of independent non-executive directors. There is a perception that investors will not accept that any director who has served more than nine years can be considered to be independent. Provision A.3.1 of the Combined Code makes it clear that none of the circumstances identified in that provision prevent an individual from being considered independent both in character and judgement; they are simply factors that the board should take into account when determining whether the director is considered independent (although the company is required to provide an explanation where any of those circumstances apply).

36. There is no evidence that shareholders will not accept that a director can be considered independent after serving more than nine years. According to Deloitte around 10% of all non-executive directors in the FTSE350 had been in position for ten years or more⁷, and Manifest found that 16% of smaller listed companies had at least one independent director who had served more than nine years. This would appear to suggest that, where a clear explanation is provided, shareholders are accepting in principle that a long-serving director can remain independent.

37. Some companies continue to raise concerns that some investment institutions and rating agencies apply criteria that are different to those set out in the Code when assessing a company's corporate governance practices. In January 2005 Hermes announced that it was discontinuing its separate corporate governance guidelines and would henceforth assess companies against the principles and provisions of the Combined Code. This decision was welcomed by companies, and the FRC would encourage other investors to follow Hermes' example if they have not already done so.

⁷ 'Board structure and non-executive directors' fees', Deloitte, September 2005.

Has the Code had an impact on the level and quality of dialogue between boards and their shareholders?

38. Both companies and investors reported that the dialogue between boards and their major shareholders was in the main more constructive than it had been a couple of years ago. In its response to the review the Investment Management Association commented that “in recent years the level and quality of dialogue between boards and their shareholders has improved and the Combined Code has contributed to this... Furthermore, company chairmen tend to be more proactive in meeting institutional investors”.

39. There is evidence of greater engagement on the part of investors. Voting levels have increased. RREV found that the average voting level across the FTSE All Share in the year to June 2005 was 63%, while Manifest reported that the average voting level for FTSE100 companies in the year to August 2005 was 59%, up from 54% in 2003⁸.

40. Surveys conducted by NAPF and the IMA have found that fund managers have committed more resources to engagement with companies over the last two years⁹. Even so, because they invest in a large number of companies it is not always possible for investors to maintain the level of ongoing dialogue they might wish with all investee companies, and in particular smaller listed companies. Where that is the case, it is all the more important that investors be prepared to enter into a dialogue where they have concerns about a company’s governance policies to ensure that they are making an informed assessment.

41. There remains a perception among some companies that the fund managers and corporate governance specialists within some institutions do not always take a consistent position or place the same importance on governance issues. Following discussions with the CBI, the IMA produced guidance on this issue in October 2004, which recommended that institutions identify a lead contact for each of their investee companies¹⁰. The FRC would encourage those institutions that have not already done so to adopt this good practice.

⁸ Figures quoted in ‘Review of the impediments to voting UK shares – an update on progress’, a report by Paul Myners to the Shareholder Voting Working Group, November 2005.

⁹ ‘Pension Funds’ Engagement with Companies 2004’, NAPF, August 2005 and ‘Survey of Fund Mangers’ Engagement with Companies’, Investment Management Association, January 2005.

¹⁰ ‘Relations with Investee Companies – Guidance on Good Practice’, Investment Management Association, October 2004.

42. As a result of the review, the FRC is consulting on whether to amend the Code to provide shareholders voting by proxy with the option of withholding their vote, and to require the publication of details of proxies lodged at the AGM where votes are taken on a show of hands, as recommended by Paul Myners in his January 2004 report to the Shareholder Voting Working Group¹¹.

43. A follow-up report published in November 2005 recommended further changes to polling procedures at the AGM to be incorporated in section D.2 of the Code¹². The existing requirements for polling procedures and subsequent disclosure of results may change as a result of the Company Law Reform Bill and the anticipated EU Directive on shareholders rights. The FRC does not therefore propose to recommend further changes to the Code at this point, but will revisit this issue in the light of developments.

What impact has the Code had on smaller listed companies, in particular those outside the FTSE350?

44. Data on the extent to which smaller listed companies are choosing to follow the provisions of the Combined Code rather than explain is only available for the 2004/05 reporting round, so it is not possible to identify any trends. The Manifest research into listed companies outside the FTSE350 found that many were following some of the long-standing provisions in the Code (for example, over 90% had separated the roles of chairman and chief executive) while, in general, fewer were following some of the provisions added in 2003.

45. In its response to the review the Quoted Companies Alliance commented that “overall, it is our impression that there have not been any very major insurmountable difficulties in implementing the new Code”. However, some of the issues identified in this report can be more pronounced for smaller listed companies. For example, the resources required to follow the provisions of the Code are proportionately higher, and investors are less likely to keep up an ongoing dialogue with companies that are a relatively less significant component of their investment portfolio.

46. Good governance is as important for small companies as it is for large ones, but appropriate governance practices may differ. Some of the investors that responded to the public consultation stated that they take the size of the company into account when assessing how it has implemented the Combined Code, as recommended in the preamble to the Code, and the FRC would encourage other investors to do the same.

¹¹ ‘Review of the impediments to voting UK shares’, a report by Paul Myners to the Shareholder Voting Working Group, January 2004.

¹² ‘Review of the impediments to voting UK shares – an update on progress’, a report by Paul Myners to the Shareholder Voting Working Group, November 2005.

Broader application of the Combined Code

47. Another indicator of the positive impact of the Combined Code and the 'comply or explain' approach is the extent to which it has been adopted as the model for corporate governance in sectors other than listed companies and in other countries. For example, in the UK the Building Societies Association and the Association of Mutual Insurers have both adopted annotated versions of the Combined Code as the corporate governance standard for the sectors they represent, while the majority of other EU Member States now have in place a 'comply or explain' corporate governance code.

POSSIBLE AMENDMENTS TO THE CODE

48. When the review was announced in July 2005, the FRC stated that changes would only be considered if there was a strong consensus that they were needed, and a commitment was given to carry out further public consultation on any proposed changes before they were implemented.

49. Almost all respondents said that they did not consider significant changes to the Code were necessary at this stage, and agreed with the FRC that it was appropriate to have a period of relative stability while the changes introduced in 2003 bedded down.

50. Notwithstanding that, many respondents also identified changes that they considered could be made to the Code. The proposals that were put forward most frequently are listed in the summary of responses (available on the FRC website at www.frc.org.uk/corporate/combinedcode.cfm).

51. In the light of these comments, the FRC has decided to consult on a small number of possible changes to the Combined Code. These would:

- amend provision B.2.1 to allow the chairman to sit on the remuneration committee where he or she was considered independent at the time of appointment;
- amend section D.2 to provide shareholders voting by proxy with the option of withholding their vote, and to require the publication of details of proxies lodged at the AGM where votes are taken on a show of hands;
- for those provisions that require companies to “make information available” (provisions A.4.1, B.2.1 and C.3.3), enable the requirement to be met by placing the information on the company’s website; and
- set out in Schedule C of the Code the disclosure requirements in the Listing Rules in order to ensure companies are able to find details of all relevant requirements in one place.

52. These proposals are set out in more detail in the consultation document published alongside this report. Comments on the proposed amendments are sought by 21 April 2006. It is the intention that any resulting changes on the Code would apply to financial years beginning on or after 1 November 2006.

53. It is possible that further changes to the Code may be required as a result of new EU requirements under the revised 4th and 8th Company Law Directives relating to corporate governance statements and audit committees or changes to UK law introduced in the Company Law Reform Bill. The FRC will also need to consider the implications of the Government's decision to abolish the statutory requirement for quoted companies to publish an Operating and Financial Review and the outcomes of its current consultation on the statutory Business Review. If further changes are proposed as a result of any of these developments, there will be full consultation before any action is taken.