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Dear Mr Hodge

REVIEW OF THE EFFECTIVENESS OF THE COMBINED CODE: CALL FOR EVIDENCE

The Business Policy Committee is the Institute's committee which monitors developments in the rules and regulations affecting businesses generally and considers legislative and other proposals deriving from bodies such as the BERR, the FRC, the FSA and the European Commission. The Committee is broadly based, with members representing different sizes of accountancy practice, industry, the investment community, and the legal profession.

As the Institute's Charter requires, we act in the public interest, and our proactive projects, responses to consultation documents etc. are therefore intended to place the general public interest first, notwithstanding our charter requirements to represent and protect our members' interests.

In relation to corporate governance, we consider the public interest to be maintaining and promoting confidence in an open, transparent and credible corporate environment that enables effective decision making by all interested parties and that allows boards to demonstrate effective stewardship of shareholders' funds, accountability to shareholders and appropriate responsibility to other stakeholders.

We have noted in the attached appendix a number of general points regarding the implementation of the Combined Code and responded to the specific questions in the review paper. In summary, we do not believe that any major changes to the approach and content of the Code are required, although there may be behavioural aspects of how the Code is implemented that could be improved. In order to support this, our recommendations are that:

- All directors should be expected to uphold the highest ethical standards of integrity and probity and this should be included as a principle in the Combined Code. This principle should be clearly reflected in all statements issued by the company and set the overall tone of the business. The highest ethical standards should underpin all company communications, and be clearly seen to do so.
- Consideration should be given to producing expanded procedural guidance to assist remuneration committees in a similar manner to the Smith guidance which worked successfully for audit committees.
- A stronger emphasis should be placed on the 'explain' element of comply or explain. The Code should explicitly state that where a company explains its policies and practices in support of compliance or non-compliance this is a positive and effective means of communicating to stakeholders.
- Non-executive directors need to have relevant skills and be competent in the role and should be encouraged to be more pro-active in gathering relevant information before accepting an appointment.
- There should be a reconsideration of the emphasis on 'independence' of non-executive directors compared to their experience and knowledge of the company.
- Institutional investors could strengthen their input to the governance of the company by holding a separate meeting each year with the chairman and company secretary, and on occasion the senior independent director, specifically to discuss the governance of the company.
- For smaller companies it may be useful to establish a governance committee instead of an audit committee, remuneration committee, and nomination committee.

It should also be borne in mind that the current economic challenges have stemmed from the banking sector and we have no evidence of systematic failures of governance across all sectors. Any focus on corporate governance at this stage should not inhibit entrepreneurialism and managed risk taking.

Please do not hesitate to contact me should you wish to discuss any of the above points further. We look forward to continuing to contribute to the FRC's work on the Code and its effective implementation.

Yours sincerely



DAVID A WOOD
Executive Director, Technical Policy

APPENDIX

General points

In listed companies the provisions of the Code appear to be supported by boards of directors and retail and institutional investors. We believe that there is evidence that the implementation of the Code's principles and provisions has led to more effective governance and we do not believe that any major changes to the approach and content of the Code are required, although there may be behavioural aspects of how boards implement the Code which could be improved. The current economic challenges have stemmed from the banking sector and we have no evidence of systematic failures of governance across all sectors. However, in light of the current markets and the need to rebuild stakeholder confidence we support the FRC in this review.

In smaller companies such as AIM companies and those with ambitions to grow, the principles of corporate governance put forward in the Code are increasingly being applied. Companies in other European countries are also treating the Code as best practice and implementing aspects of it. This would indicate that the principles of the Code are considered to be useful and that corporate governance can be used to encourage good corporate and director behaviour, as well as giving a level of confidence to potential investors or funders.

Implemented effectively, on a proportionate and cost-effective basis and balanced with the realistic expectations of stakeholders, the principles of good governance should be an essential feature of the corporate landscape. As clearly laid out in the original provisions of the Code, the focus on corporate governance should not inhibit entrepreneurialism and managed risk taking and this should not be overlooked today. We also consider that trust is an important part of any relationship and further disclosure, perhaps for its own sake, is not necessarily appropriate in all situations. For example, if a shareholder would like certain information it can be requested at any time.

Specific questions

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

We believe that the Code's approach works well; the Principles and Provisions provide effective standards and we prefer this approach to the rigidity of a more detailed, formal rule book. As we discuss below, there may be limited areas which could be strengthened, for example, in expanded procedural guidance to remuneration committees, the application of the 'explain' element of comply or explain, and on pro-active information gathering by non-executive directors prior to accepting an appointment.

'Good Practice Suggestions from the Higgs Report' says that the chairman and non-executive directors are expected to uphold the highest ethical standards of integrity and probity. In our view this should be widened to cover all directors and included as a principle in the Combined Code. This principle should be clearly reflected in all statements issued by the company, for example, by the chairman, chief executive, and in half yearly and interim statements, because they set the overall tone of the business. The highest ethical standards should underpin all company communications, and be clearly seen to do so. This would highlight that ethical behaviour is at the heart of good corporate governance and the company's activities.

Have any parts of the Code inadvertently reduced the effectiveness of the board?

Emphasis on compliance at the expense of strategic initiative: We have some reservations about the level of emphasis that is sometimes attached to compliance with the Code and believe this may be at the expense of focusing on corporate strategy and entrepreneurial success. It is debatable whether attention to corporate governance is because it enables directors to run their companies more successfully or whether it provides a certain level of assurance and comfort which may be advantageous in a litigious environment. Arguably, some directors may be able to demonstrate full compliance with the Code whilst avoiding some of the strategic decisions or challenges.

Independence and length of service requirements for non-executive directors: We question whether automatic adherence to the Code provisions on independence and length of service are fully appropriate, or whether recent board performance issues have shown that non-executives require more intensive experience and knowledge of the business in order to fulfil their role effectively. The complexity of a large multinational listed company may require several years of service from a non-executive director before that director can be properly effective. The long term nature of corporate strategy may benefit from longer serving directors who have experienced the business cycles in that industry. We believe it is important to have on a board the experience both of the company and the industry and such experience is not gained in a short space of time. It is with experience that a person begins to have the confidence to challenge the rest of the board and sustain that challenge where necessary. Therefore length of service should not necessarily be seen as an aspect of non-compliance but as a potential benefit, as long as performance remains effective and the non-executive director has not assumed the role of an executive director de facto.

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

The Smith report strengthened the guidance provided to audit committees and resulted in audit committees performing more effectively. We believe that additional, similar guidance would be beneficial for the remuneration committee in the area of risk management relating to remuneration strategies.

Whilst there is already a principle that institutional investors should enter into a dialogue with companies based on the mutual understanding of objectives, discussions tend to focus on financial aspects and the strategic business direction of the company. Institutional investors might strengthen their input to the governance of the company if there was a separate meeting each year with the chairman and company secretary, and on occasion the senior independent director, specifically to discuss the governance of the company. For example, we understand that Cairn Energy plc has such meetings between the chairman and company secretary and institutional investors and finds them beneficial. Guidance on engagement between shareholders and such directors may assist in more effective engagement, whilst the generality of communication with all non-executive directors could be removed.

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

We strongly support the 'comply or explain' principle as opposed to a more rigid regulatory solution but, in practice, we do not think that it always works in the most beneficial manner for companies. Too often, 'explain' is viewed by investors as 'negative' and 'comply' as 'positive'.

As a result companies may tend to amend their procedures to secure full compliance regardless of whether it is appropriate and this can lead to unnecessary cost and administrative burdens, with little added shareholder value. The Code should explicitly state that where a company explains its policies and practices in support of compliance or non-compliance this is a positive and effective means of communicating to stakeholders. It might be useful if examples of good explanations of governance diversion were given in order to promote the acceptability of this concept.

We have mixed feedback from our members regarding the usefulness of all company governance disclosures. On the one hand, transparency suggests that there should be comprehensive governance disclosures. However, there are others who question the value of the current level of disclosure by reference to whether it leads to ‘boiler-plating’ which changes little if at all from year to year. There is a risk that ‘standardised disclosure’ does not add value to current or potential shareholders, but companies may be apprehensive of moving away from this approach in the light of possible commentator reaction. We suggest that the FRC may wish to canvass the views of institutional investors as to what disclosure is beneficial to their decision making, if there is any existing disclosure which they disregard, and whether there is other disclosure that would be helpful to inform their understanding and actions.

Content of the Code: The composition and effectiveness of the board as a whole

We support the principle that the board should include a balance of executive and non-executive directors, which is led by a strong chairman who can harness the input of all directors. The effectiveness of the board is enhanced by having non-executive directors, but the important point is that they must have the strength of character and relevant experience to challenge strategic proposals and executive recommendations effectively. It is difficult to see how the current Code could be strengthened in this respect.

For smaller companies it may be useful to establish a governance committee instead of an audit committee, remuneration committee, and nomination committee. In many small companies, all the non executive directors attend each of these committees, which is a duplication of minute taking, administration and reporting. We could envisage a governance committee having on it individuals who have specific responsibility for audit aspects, nominations aspects and remuneration aspects. Such alternative governance methods may help to allow people to think more widely of the substance of what is being done, rather than the form.

Content of the Code: The respective roles of the chairman, the executive leadership of the company and the non-executive directors

We agree with the contents of the Code regarding the roles of the chairman, the executive leadership of the company and the non-executive directors. We have concerns, however, that some stakeholders expect a non-executive role to be closer to that of an executive director’s and, at times, there appear to be unrealistic expectations of non-executives capabilities. We recognise the collective and individual responsibility of all directors, but recent corporate examples indicate that the Code and how it is perceived might be strengthened by giving examples of how the roles of executive and non-executive directors differ in, for example, the progress of a key corporate transaction or promoting a riskier strategy for obtaining business.

The role of the company secretary should not be forgotten, to ensure that good information flows within the board and its committees, and between senior management and non-executive directors.

This is a crucial role because, without this, the non-executives may not be properly briefed in order to participate fully in the board. The company secretary may not occupy the most visible position in relation to corporate governance but he/she is vital in facilitating effective board meetings and decision making. The company secretary also has a role in ensuring that boards are kept up to date in relation to legal requirements.

Content of the Code: The board's role in relation to risk management

There is already significant risk management content in the Code and in the Turnbull and Smith Reports. It may be that certain elements of the risk management framework should be considered in more detail, such as the board's appetite for risk, and how that appetite is measured. There may also be scope for further practical guidance on the speed and manner in which material risk and internal control issues and breakdowns are escalated to the company's governance bodies.

Content of the Code: The role of the remuneration committee

Although the Smith report probably added to the role and responsibilities of audit committees, it has strengthened their effectiveness. We believe that additional, similar operational and focussed risk management guidance would be beneficial for the remuneration committee.

Content of the Code: The quality of support and information available to the board and its committees

Corporate governance and the effective leadership of a public listed company are based on the premise that the executive team has both day-to-day delegated operational management responsibilities to run the company and responsibilities to develop strategic proposals to put forward for the board's consideration. The role of the non-executives is to act as a 'sounding board' which can question and test strategic proposals, help to refine them, and thereafter provide advice and support in their implementation and propose corrective actions if there are implementation difficulties. Such a leadership model can only work well if there is a suitable flow of timely and appropriate information to the non-executives, with the executives respecting and valuing the input from the non-executives. Much of this rests on human qualities and behaviour, and appointing the right people, and we doubt if any further guidance in the Code would be helpful on these 'softer' aspects of governance.

It may be that the relevant provisions in the Code could be strengthened to remind non-executive directors that knowledge of the company and obtaining information is a two-way process and that they should be proactive in:

- Ensuring that they are provided with suitable induction training, ongoing training and regular site visits in order to understand the business fully.
- Actively participating, and periodically going out and about around the company to understand its activities in order to be in a better position to assess what information is appropriate.
- Asking for occasional reports or presentations from senior managers who are not members of the board.
- Understanding the risks to which the company is exposed and how they are managed on an ongoing basis.

An effective member of the board should not simply expect that all relevant information will come to the non-executive without any further enquiry.

Content of the Code: The content and effectiveness of 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.

We have some concerns that there is not always an informed reaction from institutional investors to those companies that choose to explain rather than comply with aspects of the Code. We would encourage investors to give proper consideration to explanations and enter into an assertive but informed dialogue in order to satisfy themselves regarding these explanations. As we discuss above, effective engagement could be encouraged by a separate, regular meeting with the chairman and the company secretary, and on occasion the senior independent director. Boards could also host ‘investor days’, say annually, when investors can be shown the company’s premises, processes and products and have the opportunity to learn from management about the company. We also encourage institutional investors to re-evaluate the level of resource they invest in corporate governance engagement so that the relationship with the investee company is credible and effective.

Application of the Code: Comply or explain – have the concerns expressed in responses to the 2007 review increased or decreased in the intervening period and, if they remain, are there steps that could be taken by the FRC or others to address this?

We expressed concern in 2007 that, in practice, ‘comply’ may be viewed ‘positively’ and ‘explain’ ‘negatively’ but the intervening period has been relatively short in which to notice changing behaviours by either companies or stakeholders, or draw conclusions.