Our Ref GM/SAM
Your Ref 2009 CODE REVIEW

Corporate Governance Unit
Financial Reporting Council
Fifth Floor
Aldwych House
71-91 Aldwych
London
WC2B 4HN

**Grant Thornton UK LLP**
**National Office**
Grant Thornton House
Melton Street
London NW1 2EP

T +44 (0)20 7383 5100
F +44 (0)20 7383 4715
DX 2100 EUSTON
www.grant-thornton.co.uk

For the attention of Chris Hodge

28 May 2009

Dear Sirs

## 2009: Review of the effectiveness of the Combined Code ("Code")

We welcome the opportunity to respond on the above call for evidence. We support the approach taken by the FRC in seeking views from stakeholders, and we support initiatives to facilitate debate and discussion on issues relating to corporate governance.

### 1. Financial crisis

It is important that the Combined Code is reviewed regularly and we have welcomed the opportunity to reconsider its appropriateness every two years.

The current review takes place against the backdrop of the financial crisis. One area that inevitably comes under spotlight is the role played by corporate governance leading up to, and during, the financial crisis.

We would however caution against what could be considered knee-jerk reactions. In our view, while there are many aspects of business and corporate reporting practice that need to be reviewed, the main cause of the financial crisis was a loss in confidence in the banking sector which largely arose (in the UK and elsewhere) because:

- excessive corporate and personal borrowings had built up in the money system; Grant Thornton is on record over several years as arguing that these debt levels were not sustainable and would lead to problems for the economy

- there was a failure in the effective application of the risk management systems and governance arrangements (including the impact of remuneration on behaviours) in some banks, that failed to keep pace with the innovation that was occurring in those banks' activities

- similarly the banking regulators had not been able to keep pace with the innovation which was occurring in banks' activities.

We do not believe these failings can be addressed via changes in governance codes and we do not believe there is any evidence of wide-spread failings in the Code or its application by UK listed companies as a whole.

If changes are required to the Code, these changes must be proportionate, relevant to the business, and represent a significant step change for the better. In the current climate, businesses do not require the burden of additional administration (either in terms of cost or Board time) unless there are clear benefits in doing so. Therefore, we believe that the FRC should avoid the temptation to react to commentators who call for widespread changes to the Code unless these are supported by objective evidence that market confidence will be significantly increased as a result.

We also welcome the FRC working closely with Sir David Walker as the focus of that review is to address the issues that have arisen in the banking sector. While it is clear that the Walker review might identify proposals to changes in corporate governance arrangements in the financial services sector that are worthy of wider consideration, through collaboration, the FRC will have the opportunity to mitigate the risk of governance changes designed to address banking deficiencies impacting non-financial sectors adversely.

## 2. Mixed messages in corporate governance

Our 2008 review[1] uncovers mixed messages as to the state of corporate governance as applied by the FTSE 350. Positive trends include:

- improved levels of explanation where companies choose not to comply with the Code
- continued strengthening of the presence of independent non-executives on the boards of the mid 250
- emerging practices in Corporate Responsibility (“CR”) reporting
- high levels of disclosure in line with the new business review requirements.

However, a number of challenges remain:

- while 44% of companies claim full compliance with the Code, only a quarter of these companies make all the disclosures to support their claim
- the quality and usefulness of the explanations still vary, with significant numbers providing only the bare minimum of information or boiler plate disclosures
- 2008 saw a reduction in the number of directors on boards
- as yet, there is little consensus or independent assurance over the CR information, non-financial Key Performance Indicators and other statistics to allow comparability and objective value assessment.

In this context we do not believe there is evidence of widespread failure which would necessitate significant changes to the Code. Our research suggests that the area where improvements should be made is more behavioural, relating to the application of the Code.

[1] "Harmony from discord: emerging trends in governance in the FTSE 350" February 2009, Grant Thornton UK LLP, which tracks FTSE 350 compliance with the Code since [2003]

## 3. Behaviours

We argue in section 1 above that any changes to the Code should be based upon objective evidence. We also believe that any changes should focus on behaviours ie how the Code can be applied more effectively (where necessary). We believe that financial statements are close to reaching their limit in the amount of information that can be crammed effectively into them, and any short term improvements in governance can only be achieved by changing behaviours, for example in the way that companies' governance arrangements are challenged.

The Chairman and non-executive directors have an important role in changing behaviours. They should use their experience to evaluate corporate governance and robustly challenge the executive leadership. They should also encourage and facilitate quality dialogue with institutional investors.

The role of institutional investors is critical. Institutional investors must be encouraged to challenge the Company's compliance with the Code especially in the areas of board composition, risk management and remuneration. In order to achieve this, institutional investors must be provided with sufficient understanding of the business model and its associated risks and, in turn, they must actively challenge the Board on these areas.

Dialogue with institutional investors on strategy and compliance with the Code is already set out within sections D and E of the Code respectively, but the recent high profile failures in the banking sector suggest that the importance of this dialogue should be reinforced.

## 4. FRC's role

Following on from our comments above, it is our view that one important lesson arising from the financial crisis is that while companies have generally sought to adopt a responsible approach to comply or explain (the basis of which we support) there has generally been insufficient challenge to the explanations and disclosures made. While we believe such challenge is primarily the responsibility of investors and (in financial services the banking regulators), there are two ways in which the FRC might take on an enhanced role.

First, the FRC could consider trends in governance disclosures and key current governance topics and seek to engage companies and other stakeholders with a view to encouraging movement towards best practice.

Second, the FRC could from time to time look at the governance disclosures made by individual companies and raise questions with the companies directly, eg via the FRRP. However, given our view that there is no evidence at present of widespread governance failings of UK listed companies outside the financial services sector, we are not persuaded that the FRC should establish an additional subsidiary board with a remit to challenge governance practise and disclosures.

We believe that all stakeholders consider that current financial statements are difficult to follow, with voluminous disclosures, however in discussion with stakeholders it is difficult to identify parts of the financial statements which at least some stakeholders see as irrelevant. We do not believe the length and complexity of current financial statements facilitates a robust challenge by investors of the governance practices of companies in which they invest. We believe the time is right for an authoritative body such as the FRC to consider this area and we look forward to contributing to the FRC's complexity project. We believe that this will be a more fruitful area for FRC examination than a wholesale re-write of the Code, which we believe remains fit for purpose.

## 5. Board composition

The 'tone from the top' is critical and it is important that it remains relevant to the company's current and future circumstances. The Code currently requires the evaluation of board composition in Section A but in our view, the evaluation should capture whether the board composition is aligned with the business as it is expected to be over the next few years and not as it is now, or was in the past.

## 6. Risk management

The importance of changing behaviours is set out in section 3 above. One area which would benefit from a significant change in behaviours is risk management. We question whether the risks disclosed by certain financial services companies fully reflected the strategies that the companies were undertaking, but rather reflected more generic risks faced by companies within the sector.

Issuers should be encouraged towards more connected reporting of risks, controls and strategy, thereby placing greater emphasis on the Directors to acknowledge their responsibility for the embedding and effective operation of risk management practices. In doing so, we believe it would stimulate a far more rigorous and ultimately permanent shift in a company's approach to managing the risks around the achievement of their strategic objectives.

The FRC might consider what would be the most effective way to encourage such a behavioural shift.

This could take the form of a more detailed dedicated report requiring companies to more positively describe the relationship between risk management, controls and strategy and then for the directors specifically to confirm (perhaps as a separate statement, or as an embellishment to the present one) their responsibility for having implemented and embedded an effective risk management process encompassing appropriate internal controls and processes to manage the risks which they have identified as having a significant impact on the achievement of their strategy.

By changing the emphasis from the internal controls alone to the wider risk management, consolidating all the various disclosures into one section of the annual statement (and possibly by requiring a more positive statement of the directors) we believe a longer lasting shift can be achieved in companies internal activities which in turn are relied on to support the Directors' statement.

Our detailed responses to each question within the consultation are set out on the following pages.

If you have any questions on this response, please contact Steve Maslin (phone: 020 7728 2736; email: steve.maslin@gtuk.com) or Giles Mullins (phone: 01908 359609; email: giles.m.mullins@gtuk.com).

Yours sincerely


Steve Maslin
Head of External Professional Affairs
For Grant Thornton UK LLP
Direct T +44 020 7728 2736
Direct F +44 020 7728 2736
E steve.maslin@gtuk.com

## Appendix

### Question 1: Which parts of the Code have worked well? Do any of them need further reinforcement?

In our view the Code works well when it is properly applied. Our research in 2008 indicated that whilst 44% of FTSE 350 companies claim full compliance with the Code, only a quarter of these companies make all the disclosures to support their claim. Where a company is not compliant, only 66% are considered to provide a detailed explanation of which areas of the Code they are not compliant with. We believe this is a behavioural issue impacting application and not a result of the Code itself.

Chairman, non-executive directors and institutional investors have an important role in changing the behaviours of Companies when applying the 'comply or explain' mechanism. They must be encouraged to have open dialogue with institutional investors and robustly challenge the executive leadership.

Section A provides a suitable framework for the roles and responsibilities of chairman and non-executive directors to improve these behaviours. It also establishes the importance of ensuring that the chairman and non-executive directors are not too friendly with the executive leadership. They must be robust enough to continuously challenge executive management and use their experience to evaluate the 'comply or explain' mechanism, risk management systems and remuneration policies. The importance of their role in changing behaviours needs to be reinforced.

Sections D and E of the Code encourage quality dialogue with investors on strategy, remuneration policy and Code compliance but the recent high profile failures in the banking sector suggest that the importance both investors and the Board place on this dialogue must be reinforced.

### Question 2: Have any parts of the Code inadvertently reduced the effectiveness of the board?

No, we do not believe that the Code has inadvertently reduced the effectiveness of the board.

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

The 'tone from the top' is critical and it is important that it remains relevant to the company's current and future circumstances. The Code currently requires the evaluation of board composition in section A, but in our view, the evaluation should consider whether the board composition is aligned with the business as it is expected to be over the next few years and not as it is now, or was in the past.

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

The current review takes place against the backdrop of the financial crisis. One area that inevitably comes under spotlight is the role played by corporate governance leading up to, and during, the financial crisis.

We would however caution against what could be considered knee-jerk reactions. In our view, while there are many aspects of business and reporting practice that need to be reviewed, the main cause of the financial crisis was a loss in confidence in the banking sector which largely arose (in the UK and elsewhere) because:

- excessive corporate and personal borrowings had built up in the money system; Grant Thornton is on record over several years as arguing that these debt levels were not sustainable and would lead to problems for the economy

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We do not believe these failings can be addressed via changes in governance codes and we do not believe there is any evidence of wide-spread failings in the Code or its application by UK listed companies as a whole. Indeed to date there have been relatively few corporate failures of UK listed companies as a result of the financial crisis which in part is testament to the governance arrangements which those companies have put in place in recent years.

If changes are required to the Code, these changes must be proportionate, relevant to the business, and represent a significant step change for the better. In the current climate, businesses do not require the burden of additional administration (either in terms of cost or Board time) unless there are clear benefits in doing so. Therefore, we believe that the FRC should avoid the temptation to react to commentators who call for widespread changes to the Code unless these are supported by objective evidence that market confidence will be significantly increased as a result.

**Behaviours**

We also believe that any changes should focus on behaviours ie how the Code can be applied more effectively (where necessary). We believe that financial statements are close to reaching their limit in the amount of information that can be crammed effectively into them, and any short term improvements in governance can only be achieved by changing behaviours, for example in the way that companies' governance arrangements are challenged.

The role of institutional investors is critical. Institutional investors must be encouraged to challenge the Company's compliance with the Code especially in the areas of board composition, risk management and remuneration. In order to achieve this, institutional investors must be provided with sufficient understanding of the business model and its associated risks, and in turn, they must actively challenge the Board on these areas.

Institutional investors must 'buy-in' to the strategy and its associated risks. They should encourage the board to ensure that risks are managed to an acceptable level and any remuneration policies are designed to incentivise long-term sustainable growth and not inadvertently encourage short-term risk taking.

The Code already includes the importance of dialogue with investors within sections D and E. These requirements are considered sufficient to allow appropriate engagement by institutional investors providing behaviours change and this would be achieved through greater institutional investor engagement by Boards.

**Risk management**

One area which would benefit from a significant change in behaviours is risk management. We question whether the risks disclosed by certain financial services companies fully reflected the strategies that the companies were undertaking, but rather reflected more generic risks faced by companies within the sector.

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**FRC's role**

The FRC could also take on an enhanced role in the following two ways:

First, the FRC could consider trends in governance disclosures and key current governance topics and seek to engage companies and other stakeholders with a view to encouraging movement towards best practice.

Second, the FRC could from time to time look at the governance disclosures made by individual companies and raise questions with the companies directly, eg via the FRRP. However, given our view that there is no evidence at present of widespread governance failings of UK listed companies outside the financial services sector, we are not persuaded that the FRC should establish an additional subsidiary board with a remit to challenge governance practise and disclosures.

We believe that all stakeholders consider that current financial statements are difficult to follow, with voluminous disclosures, however in discussion with stakeholders it is difficult to identify parts of the financial statements which at least some stakeholders see as irrelevant. We do not believe the length and complexity of current financial statements facilitates a robust challenge by investors of the governance practices of companies in which they invest. We believe the time is right for an authoritative body such as the FRC to consider this area and we look forward to contributing to the FRC's complexity project. We believe that this will be a more fruitful area for FRC examination than a wholesale re-write of the Code, which we believe remains fit for purpose.