

## **Financial Reporting Council: Review of the effectiveness of the Combined Code**

On 18<sup>th</sup> March 2009 the Financial Reporting Council (FRC) announced a review of the Combined Code. Views were welcomed on the content of the Code and the way that it had been applied by companies.

In particular comments were invited on these questions: -

- Which parts of the Code have worked well? Do any of them need further reinforcement?
- Have any parts of the Code inadvertently reduced the effectiveness of the board?
- Are there any aspects of good governance practice not currently addressed by the Code or its related guidance that should be?
- Is the 'comply or explain' mechanism operating effectively and, if not, how might its operation be improved?

I declare an interest in this matter as I am a Director of Safecall Limited, a company which provides an independent, confidential means for staff through us to report concerns to the Board of their companies, including in some instances to the Chair of the Audit Committee.

I am concerned that the Board's role in risk management can become a 'box ticking exercise' rather than a principles based approach to ensure that proper controls are in place. It is important that the Code encourages a culture within an organisation that empowers individuals to be able to report problems.

In making this submission I wish to concentrate on one particular section of the Code and whether it has worked well and does it need further reinforcement?"

**Section C.3.4 states: -**

**The audit committee should review arrangements by which staff of the company may, in confidence, raise concerns about possible improprieties in matters of financial reporting or other matters. The audit committee's objective should be to ensure that arrangements are in place for the proportionate and independent investigation of such matters and for appropriate follow-up action.**

The section addresses two separate issues; firstly the need to review arrangements by which staff can raise concerns about possible improprieties in matters of financial reporting or other matters. Secondly, ensuring that arrangements are in place for the proportionate and independent investigation and follow up of such matters.

The issue of staff raising concerns is mentioned in this section and this section only. Whilst it may appear common sense that a company has such a system there is no requirement to do so.

The Code only requires a review of arrangements, it therefore follows if a company decided it does not want to have a system for staff to report such matters then as long as they review that decision they will have complied with the Code. I believe most

organisations will have some type of system, however the effectiveness is not always apparent and ineffective or inappropriate reporting procedures can be counter productive.

In the United States the requirement is clear The Sarbanes-Oxley Act requires listed US companies as well as non-US companies listed on a US stock market to establish procedures for dealing with confidential, anonymous employee submissions regarding questionable accounting or auditing matters. Companies failing to comply with these “whistleblowing” requirements are subject to heavy sanctions.

I would therefore submit that in the first part of this section the word review be omitted and the sentence be reworded as follows: -

**The audit committee should have in place appropriate arrangements by which staff of the company may, in confidence, raise concerns about possible improprieties in matters of financial reporting or other matters.**

If arrangements for staff to report matters are in place they need to be accessible, well publicised, robust and effective.

I read with interest Paul Moore’s written submission to the Treasury Select Committee regarding his dismissal from HBOS, apparently over whistleblowing issues. In describing the current financial crisis he wrote: -

*“The real problem and cause of this crisis was that people were just too afraid to speak up and the balance and separation of powers was just far too weighed in the favour of the CEO and their executive” (Para 2.24)*

Although his role was that of “Good Practice Manager” and he received whistleblowing reports he said of his Chief Financial Officer: -

*“He strongly reprimanded me for suggesting at a Group Audit Committee that a person with my role should be protected by having a direct reporting line to the non-executive in case they had to raise criticisms of the executive.” (Para 3.12)*

The Code states the objective of the Audit Committee should be to ensure that arrangements are in place for the proportionate and independent investigation of such matters and for appropriate follow-up action.

A number of our clients have, following our recommendation, chosen the Non-Executive Chair of the Audit Committee as the person to whom all reports are ultimately directed. I was somewhat surprised that Moore did not have access to a Non Executive Director and feel that if someone in his position has such access then it would help even out the balance between the Executive and Non Executive within a Board.

The final point I wish to make relates to the Audit Committee ensuring that arrangements are in place for the proportionate and independent investigation of such matters and for appropriate follow-up action.

If a report is received the company must decide what is a proportionate investigation, on a case by case basis. I am not sure that such investigations are always independent, nor am I clear on what the Code means by independent. For example the aforementioned case involving allegations made by Paul Moore was investigated by KPMG who were the auditors for HBOS. In his submission Paul Moore refers to this investigation as “supposedly independent” inferring that as auditors KPMG were not totally independent.

In my experience I have found little evidence of matters reported being investigated independently and would suggest that this is an area which requires further review or reinforcement.

In March 2004 The Institute of Chartered Accountants in England & Wales (ICAEW) issued guidance for Audit Committees on Section C.3.4 which it referred to as “Whistleblowing Arrangements”.

The guidance included a review of effectiveness as follows: -

The board ought to consider the effectiveness of whistleblowing policies and procedures on a regular basis. It should provide input to the board’s review of the system of internal control. The review arrangements should be appropriate to the size of the company, the industry(ies) in which it operates, the nature of its activities, organisational structure and internal control and risk management systems. For some companies, the internal audit function may provide relevant assurance.

The audit committee might wish to consider:

- *is there evidence that the board regularly considers whistleblowing procedures as part of its review of the system of internal control?*
- *are there issues or incidents which have otherwise come to the board’s attention which they would have expected to have been raised earlier under the company’s whistleblowing procedures?*
- *where appropriate, has the internal audit function performed any work that provides additional assurance on the effectiveness of the whistleblowing procedures?*
- *are there adequate procedures to track the actions taken in relation to concerns made and to ensure appropriate follow-up action has been taken to investigate and, if necessary, resolve problems indicated by whistleblowing?*
- *are there adequate procedures for retaining evidence in relation to each concern?*
- *have confidentiality issues been handled effectively?*
- *is there evidence of timely and constructive feedback?*
- *have any events come to the committee’s or the board’s attention that might indicate that a staff member has not been fairly treated as a result of their raising concerns?*

- *is a review of staff awareness of the procedures needed?*

I read numerous annual reports from companies in an effort to establish if they have a whistleblowing policy and to determine how effective that policy is. I find that most annual reports contain a standard line to the effect that the Audit Committee has reviewed reporting procedures and are satisfied with the arrangements that are in place. In that one line they have satisfied part of the requirements of the Code. I regularly contact companies and ask what procedures are in place and invariably they struggle to find someone who can answer the question.

The ICAEW advice highlighted the failure of WorldCom financial and accounting departments to report concerns and states: -

*“This lack of courage typically arises from employers not promoting the benefit of whistleblowing, and employees believing that they will be disadvantaged if they raise concerns. Therefore the option to remain silent is often perceived as the option of least risk by the individual and the malpractice continues undetected. As evidenced in WorldCom’s case, and numerous other cases, this can have catastrophic consequences.*

*A company’s workforce represents a valuable source of information that can be utilised to identify a potential problem, and deal with it, before it causes significant damage to the company’s reputation or its stakeholders.”*

In conclusion, I believe Code 3.4 should state that procedures be in place and clarify what is meant by independent investigation of concerns.

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