Institute of Internal Auditors
UK AND IRELAND

Mr Chris Hodge
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Sent by email to: codereview@frc.org.uk

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Dear Mr Hodge

Review of the effectiveness of the Combined Code - call for evidence March 2009

Thank you for the opportunity to contribute to your call for evidence for the review of the effectiveness of the Combined Code (the Code).

The comments of the Institute of Internal Auditors – UK and Ireland (IIA) have been developed through consultation with our members. We provide them below organised in two parts: 1) general comments and 2) responses to the questions you posed in your consultation document. In particular, we draw your attention to the following points:

- The Institute believes that the Code should place much greater emphasis on the board's responsibility for risk management,.

- Directors see great value in having access to the independent and objective assurance that a professional internal audit activity provides on all aspects of the company's activity, not just related to financial and financial reporting controls. The Institute believes that the Code should include the requirement for such an activity as a new principle of good governance.

We hope you will find our comments constructive and we would be happy to discuss any of them in more detail. We are content for our comments to be considered as part of the public record.

Yours Sincerely

Philip K. Ratcliffe

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President

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1. Introduction

The Institute of Internal Auditors (IIA) is the only body focused exclusively on internal auditing and we are passionate about supporting, promoting and training the professionals who work in it.

We have been leading the profession of internal auditing for over 60 years. Our *International Standards* and *Code of Ethics* unite a global community of 165,000 internal auditors in 165 countries.

The IIA plays an active role in the public arena, building awareness of internal auditing, promoting members' interests and challenging organisations to reach the highest standards of corporate governance.

We are committed to enhancing the recognition and professionalism of internal audit in the UK and in Ireland. To that end, we are consulting with our members and other stakeholders about the award of Chartered status, which will acknowledge qualified internal auditing professionals as experts in their field, offering a clear differentiator between internal audit professionals and others.

2. General comments

The need for a review

The Institute welcomes the initiative of the FRC in bringing forward its review of the Combined Code in the light of recent events. We recognise that the FRC's focus is the Code and that the Code is only one aspect of governance in the UK. We are aware of and also welcome the more wide-reaching review being undertaken by Sir David Walker. Although this is focussed for the time being on the financial services sector, we believe that its conclusions are likely to be relevant beyond that sector.

In this response, we concentrate on the aspects of the Code that we believe need strengthening. We are also submitting evidence to the Walker Review and we will be happy to provide those to you.

What is governance?

When considering the detail of the Code, it is possible to forget the overriding purpose and principles of governance. There is no universally accepted definition but the usual phrasing in the UK, based on the Cadbury report, talks about the "direction and control of the company" and cites core principles of good governance: accountability, probity and transparency; to which equity is often added. These are the overriding outcomes that we want to see from well governed organisations.

> **Recommendation**
>
> Include in the next version of the Combined Code a restatement of the fundamental purpose – to direct and control the company – and principles – accountability, probity and transparency – of corporate governance and a requirement that, above all else, directors should seek to achieve those outcomes.

Limitations of governance

The Institute believes that organisations that apply the principles of good governance are more likely to achieve the objectives of their owners and other stakeholders over time than those that do not. Therefore, in general, we support the efforts to improve governance in any sector.

However, the Institute also recognises the limitations of governance. Well governed organisations can make mistakes. More importantly, well governed organisations can still face risks that crystallise and threaten the survival of the organisation. It is important that we do not burden the governance framework with unrealistic expectations.

> **Recommendation**
>
> Include in the next version of the Combined Code a realistic statement of what investors can expect from well governed companies and of their own responsibilities.

Public interest role of directors

The Institute is conscious that the current discussions about corporate failures include discussion of the public or external cost of corporate failure.

The Code focuses on the role of directors in directing and controlling companies for the benefit of shareholders, including setting directors' remuneration in order to align their objectives with those of the company. Part of the reasoning behind this is that this is a belief that companies run for the benefit of shareholders will provide the best benefits for the economy and society as a whole.

However, there is no reason why shareholders would always have an aim, which promotes the good of the economy as a whole, even if you can align directors to that goal. There is also the issue of the asymmetry of rewards both at an individual and social level – private individuals benefit from the good times; the public as a whole suffers in the bad.

This therefore raises the question whether directors of companies should also play a public interest role. It may be considered too onerous to require all directors to play this role. Perhaps there would need to be a spectrum based on the nature of the companies they run. So, at the extreme, companies that are "too big to fail" will have to have directors who have an eye for the public interest and who, therefore, will need to understand how the risks to the wider stakeholders, including society as a whole, are being managed and will wish to receive assurance on the effectiveness of this management.

> **Recommendation**
>
> Consider the need to include public interest as one of the responsibilities of directors.

Conflict between the Companies Act and the Combined Code

The 2006 Companies Act established statutory duties for directors of companies. These are (with their section numbers):

- 171 Duty to act within powers
- 172 Duty to promote the success of the company
- 173 Duty to exercise independent judgment
- 174 Duty to exercise reasonable care, skill and diligence
- 175 Duty to avoid conflicts of interest
- 176 Duty not to accept benefits from third parties

Section 172, the duty to promote the success of the company for the benefit of its members **as a whole** requires directors to consider the interests of other stakeholders. This provides at least a confusion between statute and the Code if not an actual conflict since the preamble to the Code focuses on shareholders.

In addition, the Companies Act lays down the requirement for a business review to be included in the directors' report in part to make directors accountable for the S172 duty. Since section C of the Code concentrates more on Financial Reporting, it is not clear how this aspect of accountability is facilitated by the Code.

> **Recommendation**
>
> Identify how the Code can provide guidance to directors on how to fulfil all their duties and include principles to assist directors.

3. Detailed response to your questions

Which parts of the Code have worked well?

The lack of a "one-size-fits-all" approach is what has worked well. Seeking to identify principles and accepting that each company is able – and should – decide how best to apply those principles has been powerful. It has even allowed the idea of governance and the principles to be adopted in other sectors – government, charities, etc.

Do any of them need further reinforcement?

General

Several of the principles require simply that a procedure is in place. It would be more in keeping with the approach above if they stated more clearly the outcome that we expect companies to achieve, leaving it to them how to achieve that out.

> **Recommendation**
>
> Redraft principles such as A4, A6, B2 and others where the principles ask simple for a process or procedure. The revised principle should express the outcome that is desired.

Independence of judgment

There are several principles and provisions that discuss the independence of directors, particularly non-executive directors. The aspects of independence that are included are often what we might call structural or relational aspects (Provision A.3.1). However, this ignores the statutory duty of "independence of judgement", which applies to all directors.

"Independence of judgement" is similar to the professional internal auditor's objectivity. In the International Professional Practices Framework of the Institute of Internal Auditors, we distinguish between organisational independence and personal objectivity. Both of these qualities are important but, significantly, independence on its own cannot guarantee objectivity. Objectivity can be impaired – or be seen to be impaired – by a lack of independence. However, knowledge, understanding, a certain challenging frame of mind and courage can provide more objectivity or independence of judgement than can rafts of requirements for structural or relational independence.

> **Recommendation**
>
> The core principle should be that directors should be objective, bringing independent judgement to bear and avoiding conflicts of interest. Guidance on relational independence can then be subsidiary principles or provisions, helping to support objectivity.

Alignment of risks and rewards

The overall principles related to directors' remuneration wish for the outcome to be that rewards should be linked to company and individual performance.

What is not clear from this is that the directors should share in both the upside and the downside of their performance.

Recommendation

The remuneration principles should clearly state that alignment of performance includes both upside and downside results.

Presentation of the requirements of the Code

The Code has grown up through the development of a number of reports since the early 1990s and the requirements are now spread over several documents: the Code itself, the Guidance on Audit Committees, the Turnbull Guidance on Internal Control and the Higgs Report. As a result, its structure today does not lend itself to an easy understanding of all the principles. This compares unfavourably with the draft Code of Governance Principles for South Africa – 2009 from the King committee on governance (King III), where all the requirements are gathered together in one document.

Recommendation

For future editions of the Code, consolidate and combine all the guidance into one document.

Demonstrate the board's accountability for key outcomes

The Code includes requirements for several effectiveness reviews. These include:

- The performance evaluation of the Board
- The group's system of internal controls
- The internal audit function
- The external audit process
- The audit committee

The weakness of the present Code from the point of view of stakeholders is that Annual Reports are required only to confirm that an effectiveness review has been carried out. No information is given as to the results of these reviews. This means there is no transparency and limited accountability.

There have been many concerns expressed about the legal barriers and risks to directors in making known these results. However, given the content of the Code, there is an implication that directors are responsible for establishing effective systems of internal control or internal audit, etc. We suggest that what is needed is for directors to be publicly accountable for those responsibilities.

Recommendation

Include a requirement for the board to include in its directors' report a statement that the system of control is sound and that the audit committee, internal audit and external audit are effective. This is the board's judgement and will no doubt take into account the results of the reviews of effectiveness but it also takes into account other work they have done.

Similarly, include a requirement for the Chairman to provide a judgement on the effectiveness of directors and of the board as a whole.

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

Emphasis on non-executive directors and independent non-executive directors

The current Code requires "…a balance of executive and non-executive directors" (Main principle A.3) and "…at least half the board … should comprise [independent] non-executive directors" (A.3.2.). This may have resulted in some probably unintended consequences.

We now see many boards where, far from a balance, there is a preponderance of INEDs, and where the only executive director presence is that of the Chief Executive and the Finance Director. This means that in many companies the INEDs can see the operations of the company only through the lens of the Chief Executive and have no easy way in board meetings of cross-checking that view with any other executive director, other than for financial matters.

The further corollary of this situation is that the legal board and its directors, subject to the weight of company law and corporate governance codes, are shadowed by a de facto board of executive managers who are completely unbound by many of the tenets of corporate governance. The Code has inadvertently created a two-tier board structure, but one where the second tier is all but invisible and out of the range of legislation and code. This cannot be a good thing for transparency.

> **Recommendation**
>
> Enhance the Code to encourage a better balance between executive and non-executive directors, eg add a requirement that a minimum of 40% of boards shall be executive and a minimum of 40% shall be non-executive.

Conflict between independence and knowledge or experience

The overall effectiveness of the Code relies implicitly to a very great extent on the value of an independent non-executive director as a foil to any potential excesses and abuses of executive management. It assumes that the right INEDs will be able to identify when executive management does something inappropriate, and that they will be able to hold executive management to account and redress the situation where necessary.

If we examine the qualities required of an INED they include the following:

- They have never worked in the company, or at least, not recently, and therefore have no experience of the industry by that route.
- They are almost certainly not working for a competitor in the same industry as that would represent a clear conflict of interest.
- Whereas they could in theory work in the same industry in another country, that is unlikely in practice.

It is worth making explicit that which does not normally need to be said – INEDs bring no detailed experience of the company of which they are board members or any in-depth knowledge of the specifics of its business. Particularly, now that many boards are dominated by INEDs, this relative ignorance seems damaging to the public interest.

Under British law, INEDs are equally responsible for a company whose business they cannot fully understand as the chief executive. In view of the foregoing, by definition, INEDs are responsible for companies on whose business they are complete amateurs at the time they take up their board directorships. Furthermore, as explained above under the heading "independence of judgment", these stringent requirements for relational independence do not by themselves guarantee objectivity.

> **Recommendation**
>
> Review the requirements for independence and consider relaxing them so that knowledgeable individuals can be brought onto board. This may include retired executive directors if other safeguards are in place.

Delegation of directors' responsibilities to committees

The Code has established and emphasised the importance of several committees: nominations, remuneration and audit. While this has had benefits in providing a focus and more time to discuss certain key issues, it has probably reduced the board's sense of ownership of the matters discussed.

All of the matters discussed by these committees are the responsibility of the directors operating as a board. It is important that each director feels and is held accountable for all of these matters.

> **Recommendation**
>
> Revise the principles to be clear that it is the board that is responsible for all the matters that are currently ascribed to committees. Clarify that the establishment of a committee is simply a way for the board to fulfil its responsibilities.

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

Broader scope

In the UK and Ireland, we tend to see governance being about the matters that are currently discussed in the Code: selection, management and remuneration of directors, financial reporting and related control elements, and dialogue with shareholders.

However, from international sources it is clear that governance includes other subjects. It is not that we do not include those in our governance regime here but rather that some of the matters that have to be in place for good governance are – and have been for many years – recognised in legislation. This includes shareholders' rights and, more recently, disclosures related to directors' remuneration.

Other aspects that are not covered in the Code are included below.

Performance and conformance

It is possible to read the Code as if it painted a picture of governance being only about conformance with rules of behaviour and not about driving performance. However, the original definition of governance spoke about direction and control and the current preamble is clear that the aim is good performance. However, the content of the Code does not help support that.

> **Recommendation**
>
> In addition to the principles related to accountability, include in the Code principles related to other responsibilities of the board: strategy, performance monitoring and risk management.

Management of risk

It is particularly noticeable, given recent events, that the management of risk is not mentioned in the Code as a core responsibility of the board.

The Institute would like to emphasise that there are three distinct aspects to the management of risk.

Firstly, we believe that risk management is an essential part of management. Everyone in an organisation has a role to play in identifying and responding to risks; and for managers, part of their responsibilities as managers is managing risks, including monitoring how well risk responses are working and reporting on that up the line in some way that enforces their accountability. This is the heart of risk management.

Secondly, there are specialist "risk management functions" who support the line managers with this work. They facilitate risk management activities in general by measuring, monitoring and reporting on the extent to which risk appetite and risk tolerances are met or exceeded and providing a challenge that is independent of those incurring the risk. They assist organisations to be consistent in its risk management activities. However, the activities all form part of the ongoing risk management process and should they cease to function, the organisation would not be able to manage its risks effectively day to day.

Thirdly, internal audit provides assurance activities that are part of the governance process but sit outside of the risk management process. These activities regularly conclude on the effectiveness of each element of the process and of the process overall. Internal audit may (and indeed should) use the outputs of risk management activity in forming its conclusions. Assurance activity is effective only where it is independent of all elements of the risk management process. Should assurance activity cease, the organisation would be able to continue to manage its risks effectively day to day, but we would question the effectiveness of the organisation's governance.

Therefore, the Institute believes that well governed companies have a board that is responsible for risk management and also, as the next heading demonstrates, has access to independent and objective assurance, We believe that it is important to clarify that these are separate and distinct activities.

Recommendation

Risk management should be identified as a core responsibility of the board, as part of its general responsibilities to direct and control the organisation. Include a principle that the board is responsible for risk management and place it in a separate section from the Accountability and Audit section.

Importance of independent and objective assurance – internal audit

In undertaking all of their responsibilities, directors are dependent upon receiving information. It is not just the information itself that is necessary but a way of understanding the relevance and reliability of that information. The availability of independent and objective assurance from professional internal auditors can assist directors in understanding these aspects and can help them in formulating their overall views on the effectiveness of the system of internal control.

The Code provides some recognition of the value of internal audit. It does require companies to refer to internal audit in their annual reports – either as part of the work of the audit committee when internal audit exists or as an explicit topic of explanation if it does not.

Furthermore, the existence of professional standards and key aspects of the role and independence of internal audit are included in the Guidance for Audit Committees.

However, the Code does not yet include the need for internal audit as a principle of good governance, unlike the need for, say, audit committees and nominations committees. Furthermore, the need for internal audit is somewhat buried, within the section on Accountability and Audit and subsidiary to the duties of the audit committee.

In contrast, the draft King III includes specific sections on internal audit. However, it would valuable to recognise the importance to the board of having a professional source of independent and objective assurance on all aspects of directing and controlling the company, not just one aspect.

> **Recommendation**
>
> Add a principle that the board should have access to independent and objective assurance from a professional internal audit activity. This principle should be included with the other responsibilities of the board discussed above, not just in the accountability and audit section.

The existence of other stakeholders, not just members or investors

The preamble to the Code talks about "helping a board discharge its duties in the best interests of shareholders" and "shareholder value over the longer term". This focuses on only one of the stakeholders of a company.

Governance practice elsewhere, eg King III, and even the UK Companies Act 2006 suggest there are other stakeholders whose interests should be taken into account. It would be helpful to directors if the Code could provide guidance on meeting all their duties.

> **Recommendation**
>
> Revise the Code so that it requires the board to identify all the relevant stakeholders and the reporting that must be made to them.
>
> Revise the existing principles of the Code where necessary so that they are inclusive of all or any stakeholders identified by the board. For example, main principle C1 would need to include all reporting, not just financial reports; and section D would need to cover all stakeholders.

Is the 'comply or explain' mechanism operating effectively?

There is anecdotal evidence that directors do seek to comply with the Code and, therefore, that it has some force.

However, international developments have moved away from this phrase, partly because many organisations feel that the word "comply" implies that there is little flexibility – the very opposite of the intention here. A variety of phrases are now in use: "comply or explain"; "adopt or explain" and "apply or explain". A fuller explanation of the arguments if provided in the introduction to the draft Code of Governance Principles for South Africa – 2009 from the King committee on governance (King III).

Furthermore, although the phrase has served as a useful sound bite, it does not actually explain the situation in the UK. There is no all-encompassing requirement to comply with the Code or explain the non-compliance. Companies listed on the London Stock Exchange are required by the listing rules, not to comply, but to make disclosures about their compliance. In fact, listed companies are required to explain how they apply the principles, which might be thought to be the most important part of the Code. In addition, they must disclose whether or not they comply with the provisions.

Therefore, companies face penalties from their market regulator only if they fail to disclose.

Clearly, this reinforces the idea that the main mechanism for enforcing good standards of governance is via the market and the main players are the investors and members. However, as we note below, this may not be enough if we accept that companies have other stakeholders whose interests need protecting.

If not, how might its operation be improved?

Given all the substantive issues related to governance at the moment, it may not be considered an important point to change the phrase used. However, communicating ideas is often as important or more than the quality of the ideas themselves. Therefore, the relaunch of a revised Code might benefit from changing the language used to explain the UK's mechanism.

More significantly, we believe that at a minimum the mechanism should be changed to emphasise that companies are expected to apply the principles of good governance.

> **Recommendation**
>
> The Institute recommends that the mechanism be changed so that companies are expected to apply the principles of good governance, as well as making disclosures explaining how they have done that. Non-application of the Code should be the exception, to be condoned only in exceptional circumstances.

Views are invited on the usefulness of company disclosures and the amount and quality of engagement by investors.

We have no comment on the usefulness of company disclosures.

In terms of the amount and quality of engagement by investors, we believe that this is a matter for the investors and for their shareholders or investors. Where the quality of corporate governance is important to an investor, then we would expect the investor to prioritise these matters. However, we do not believe that we can as a society rely on investors to police matters that are important to the wider community of stakeholders and not to them as investors.

Content of the Code – while respondents are welcome to comment on any aspect of the Code, the FRC would particularly welcome views on:

The composition and effectiveness of the board as a whole

As noted above,

The respective roles of the chairman, the executive leadership of the company and the non-executive directors;

See comments above.

The board's role in relation to risk management;

The Institute believes that there is a varied standard of understanding amongst boards of their responsibilities related to risk management and that, frequently, only lip service is paid to this requirement.

The board is responsible for setting the tone for risk management. Part of setting the direction of the company is about deciding how much risk to accept – the risk appetite. Part of controlling the company is establishing an open culture with the right incentives and providing adequate resources so that managers can identify, respond to, monitor and report on risk. The board is responsible for forming a view of the company's management of risk. The board can do this in a complex organisation only by receiving and reviewing reports from the organisation. To assess these, it needs to understand the business.

The Code obscures the importance of risk management to the strategic health and performance of the company because it fits it into a section on accountability and audit.

> **Recommendation**
>
> Include in the Code a new principle on risk management separate from the accountability and audit section. Consider including supplementary principles and provisions, which capture the board's role in relation to risk management.

The role of the remuneration committee;

Although it is difficult to capture the issues of behaviour in codes of best practice or legislation, as internal auditors we are fully aware of the importance of this element in ensuring a sound system of control. It is this element that the actions and decisions of the remuneration committee influence and it is why it is important to us.

The Institute believes that remuneration committees need to concentrate more clearly on the way that remuneration drives behaviour. This includes understanding both the intended and the unintended consequences of the decisions they are taking.

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

The fundamental requirement is that directors understand the business and are prepared to ask questions and to ask for the information they need to understand the decisions they are taking. It is not just the information itself that is necessary but a way of understanding the relevance and reliability of that information. The availability of independent and objective assurance from professional internal auditors can assist directors in understanding these aspects.

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.

It is not entirely clear why this section is included in the Code.

If it is to protect the wider shareholding public by setting better standards for institutional investors, then it would be better done in the Code of the institutional investors themselves.

If it is related to the idea of focusing on institutional investors as a key player in enforcing good governance standards, then the Institute has some concern about the conflict of interest that creates for those investors.

Institutional investors may or may not wish to hold investments over the long term. If they do, then this provides a motivation to engage with companies where standards of governance do not meet the investors' requirements.

However, it is also entirely reasonable for investors to react to companies' actions by selling the shares of companies with whose actions they do not agree, not by engaging with them. This may serve to signal to the directors that their governance standards are not adequate. However, this message may be lost in others, not least because investors have many other reasons for buying and selling shares.

At the same time, this section and part D of section 1 force directors to spend time with institutional investors when they should be considering all their shareholders.

- ENDS -