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Dear Chris

## **Review of the effectiveness of the Combined Code: Call for evidence**

### **1. Introduction**

Mazars, the leading integrated international accountancy organization with 10,500 professional staff in 50 countries is pleased to submit its views on the above consultation.

### **2. Overarching views**

#### **2.1. *Boards are at the heart of good governance***

We recognise that in the current climate there will be a tendency to seek more regulation to deal with corporate governance matters which need to be addressed. Whilst some recalibration of the balance between regulation and market-led governance is necessary, especially in the financial sector, it is vitally important to recognise the pivotal role of the board in promoting good governance. We believe that getting the right board in place and ensuring it achieves its full potential are the cornerstones of effective governance. In a successful market economy focused on long-term sustainable wealth creation, boards must have the responsibility for striking the right balance between entrepreneurship and risk management.

#### **2.2. *Support for full review***

The market-led approach enshrined in the Combined Code must, however, respond to changes in the business environment and just as the present code is based on the late Sir Derek Higgs' review in the light of the Enron and WorldCom scandals so it is right that another thorough review be undertaken now following the collapse of a large number of leading financial institutions around the world.

#### **2.3. *Focusing change where needed***

We believe that the broad architecture of the Combined Code continues to be appropriate and that it is in the banking sector that most change is needed. In such circumstances, care should be taken not to introduce changes in governance across the corporate sector as a whole

without them first passing a robust cost/benefit test. That said, we do believe there are some areas in which it would be worthwhile to consider change as part of a process of continual improvement which boards should embrace in their corporate governance practices as in all other parts of the business. Our proposals for change are discussed below.

### **3. Parts of the Code that have worked well and areas that are in need of reinforcement**

#### **3.1. *Focus on the FTSE 350***

Whilst our overall view is that the Combined Code is generally working well we do believe there are a number of areas for possible reinforcement six years on from when the current code was launched in substantially its present form. We believe a number of these improvements would best be applied to just FTSE 100 or to FTSE 350 companies and would encourage the Financial Reporting Council to consider applying such a filter when looking at any changes to the Combined Code.

#### **3.2. *Role of institutional investors in corporate governance***

The review of the Combined Code should assess the effectiveness of institutional investors in monitoring its application by listed companies. It should consider whether enough resources are being devoted to governance issues, whether the governance teams in institutions have appropriate influence when fund managers make decisions on investments and whether consistent messages are given to companies in which an institution has invested by the governance and fund management teams respectively. The review should also consider what action institutions should take when they are unable to resolve governance issues satisfactorily with boards through private discussions including whether they should make their concerns known publicly. We recognise that this raises sensitive issues when the preferred route may be to sell the shares and walk away or when disclosure may adversely impact the share price.

#### **3.3. *Ensure disclosure not boilerplate***

We believe there should be a thorough review of the disclosure called for under the Combined Code especially that arising from explaining how the principles have been applied. There would be merit in considering a new approach aimed at reducing boilerplate disclosures with boards, for example, called on to discuss:

- their strategy and how the board keeps it under review and monitors its implementation
- steps taken to get the right board in place and the board's approach to issues such as succession planning and diversity
- the board's approach to attracting and retaining executive directors and staff and to motivating them to achieve the company's mission
- how the board promotes a culture of challenge and support in the boardroom
- how the board seeks to ensure it is working effectively as a team
- the board's risk appetite, the principal risks, and the board's approach to managing risks
- how the board keeps the performance of the business under review

#### **3.4. *Important focus on the work of board committees***

The work of the board's committees – audit, nominations and remuneration – should form another important element of the review both in terms of the work they carry out and the disclosures they make on their activities.

### 3.5. *Audit committees – dealing with the ‘choice’ agenda*

As the recent report on progress on implementing the Market Participants Group’s recommendations on enhancing choice in the audit market highlights, only very modest progress has been made to date in this important area. To help move matters forward, the related recommendations in the October 2008 edition of the (Smith) Guidance on Audit Committees should be incorporated in provisions in the Combined Code. Companies should be called on to state when the current auditors were first appointed, the date the audit was last put out to tender and the policy on tendering frequency. The provisions should also ask for disclosure of any contractual obligations (eg in bank covenants) that restrict the audit committee’s choice of external auditors.

3.6. Consideration should also be given more broadly to the content of the report of the audit committee’s work and to the desire of many institutional investors for this to be more informative in many instances, for example by covering issues discussed with the external auditors.

### 3.7. *Nominations Committee*

There remains significant concern, recently expressed again in the financial press, that boardrooms of listed companies are not sufficiently diverse in terms of their composition, both with regards to the number of female directors and to those from ethnic minority backgrounds. It is vital that boards choose the best candidate to fit their needs at a given time and this requires both a careful specification of the preferred candidate’s profile and a thorough and fair recruitment process.

It would be helpful for the review to consider whether further disclosure on the work of the nominations committee would be helpful, including discussing the reasons why new directors were selected and actions being taken by the board to increase diversity, among both the executive and independent directors, where this was considered a desirable goal by the board.

### 3.8. *Remuneration Committee – time for broad-based review*

Whilst recognising that most of the focus of recent discussions on remuneration have focused on the banking sector, we believe it would be timely to take a broad-based look at the guidance in this area as it has not received much attention for a number of years.

An assessment needs to be made of the extent to which current remuneration practices are generally aligning shareholders’ and directors’ interests and of circumstances where this linkage seems to falter. The role of remuneration consultants also merits review.

### 3.9. *Risk management*

Successful risk management is crucial to the long term success, and indeed the survival, of all businesses. We therefore believe the Combined Code should make very clear that the board as a whole has responsibility for the effectiveness of the company’s risk management and internal control systems and that while the board may delegate various activities in relation to monitoring them to, say, the audit committee, it cannot delegate its overall responsibility to ensure the appropriate systems are in place and are working as intended.

The business review requires companies to state their principal risks. We believe the Combined Code should indicate that they should also state how they have been managed. In

addition, companies should be called on to disclose any significant changes that have occurred in their risk profile during the year. In certain circumstances, it may also be appropriate to disclose such changes to the market as they occur or become known.

**3.10. *Independent secretariat for board and committees***

We believe it would be helpful to look at asking boards and committees to consider specifically as part of the annual evaluations process whether they have sufficient resources available to them and whether they consider they are receiving all the necessary information needed to discharge their duties effectively. We also believe it would be helpful for the company secretary to have their main reporting line to the chairman including on appraisal/remuneration issues though obviously one would expect the chairman to consult with the chief executive.

**3.11. *Periodic external board evaluations***

We recommend that the existing provision on board, committee and director evaluations be strengthened by calling on boards to have them externally facilitated by individuals or firms with relevant expertise at least once every three years. Boards should also be asked to disclose the name of the external facilitator together with a summary each year of follow up actions by the board in the light of the evaluation, whether externally facilitated or internally led.

Evaluations were a major new feature of the Combined Code which was developed following the Higgs Review and good progress has been made on them by many boards. But the rigour with which they are carried out does vary between boards and it is considered that the proposal above would strengthen the overall quality of evaluations.

**3.12. *Chief Executive's responsibility for providing information to the board***

The Combined Code currently states that the chairman is responsible for ensuring that the directors receive accurate, timely and clear information. We believe this responsibility should be shared with the chief executive and other executive directors on the board as they have primary control of the relevant information.

**4. *Have any parts of the Code inadvertently reduced the effectiveness of the board?***

4.1. There does seem to have been a reduction in the number of executives on some boards which some, perhaps unfairly, attribute to the requirement for FTSE 350 companies that at least half of the board, excluding the chairman, should be made up of independent directors.

4.2. We believe that it is generally better for FTSE 350 boards, in striving to get the right balance between executive and independent directors, for there to be more than two executives on the board. If there are three executive directors on the board this suggests a minimum board size of seven members and, if four, of nine members. This does not seem unduly large for major listed companies.

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

5.1. We are not aware of any such aspects.

**6. 'Comply or explain' mechanism**

- 6.1. Concern is sometimes expressed that when boards decide to depart from a provision of the Combined Code the information provided is sometimes more in the form of a description of the fact of departure rather than the reasons for it. The overall quality of disclosure on corporate governance issues also varies between companies. Furthermore, there is the inherent problem in a market-led system, where in practice it is largely left to institutional investors to monitor application of the Combined Code, that effective scrutiny by shareholders is inevitably limited when there are no institutional shareholders with a significant shareholding in the business. This is the case for a number of smaller listed companies.
- 6.2. In view of the above, there would be merits in considering a system of external review of disclosures made by listed companies in applying the Combined Code. This could be limited in scope to checking that explanations for departures from provisions are adequate. It would probably be preferable, though, for any review to look at disclosures made by listed companies generally under the Combined Code even when there was no evidence of departures from particular provisions. The monitoring could be undertaken under the auspices of the Financial Reporting Council by the Financial Reporting Review Panel or a separately constituted governance monitoring group or by an independent outside group formed for the purpose similar to the Guidelines Monitoring Group established for private equity firms by the British Venture Capital Association.

**7. Further discussion**

- 7.1. If you would like to discuss further any of the issues raised in our submission please do not hesitate to contact Anthony Carey on 020 7063 4411.

Yours faithfully

**Mazars LLP**