

# Change for the Better?

## Meeting with Peter Williams, Chair of the Investor Relations and Markets Committee of The Hundred Group

Paper prepared for the Audit Committee Chair Forum

by Dr Ruth Bender, Cranfield School of Management

The Audit Committee Chair Forum (ACCF) is convened by the CBI and Ernst & Young and is facilitated by Cranfield University.

The Forum comprises a select group of audit committee chairs from the UK's leading companies. Our aim is twofold, namely:

- to influence the direction of regulation as it impacts audit committees, and
- to act as a vehicle to develop points of view and best practice.

The Forum provides an opportunity to contribute to the debate, influence its direction and improve the performance of audit committees.

The Forum is currently chaired jointly by Richard Wilson, Senior Partner at Ernst & Young, and Helen Alexander, President of the CBI.

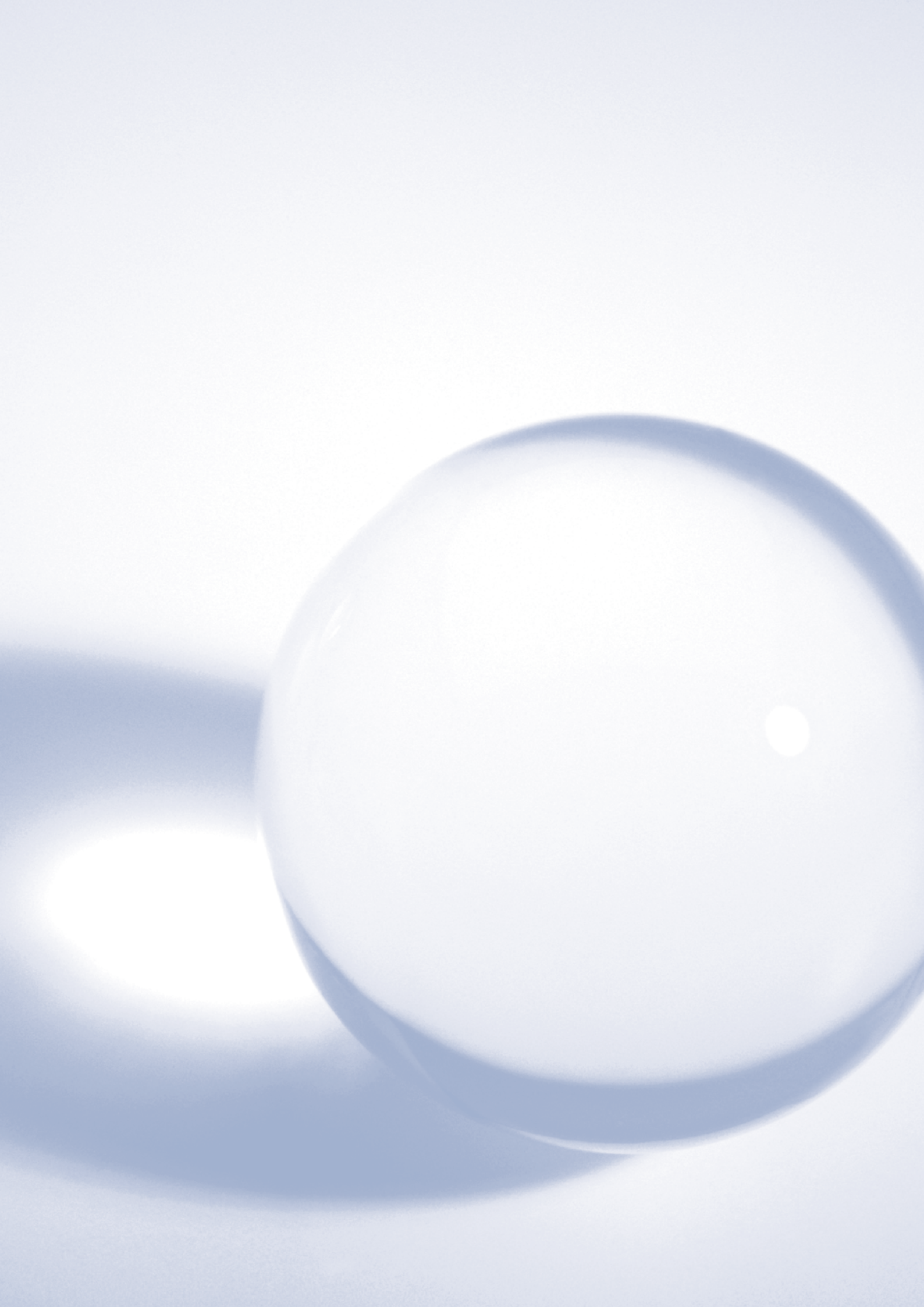
This is the twelfth paper produced by the ACCF. Previous papers include:

- The role and function of the Audit Committee
- The drivers of audit quality
- What is an effective audit and how can you tell?
- Audit Committee regulation: 'Financial literacy' – what does it mean?
- Audit Committee communication: What is said, why, how and to whom?
- The role of the Audit Committee in risk management
- The role of the Audit Committee regarding non-audited information
- The Audit Committee and the credit crunch
- Risk management in a cost-cutting environment
- A Conversation with a Regulator: Meeting with Paul Boyle, Chief Executive of the Financial Reporting Council
- Telling a good story? Meeting with Bill Knight and David Lindsell, Chairman and Deputy Chairman of the Financial Reporting Review Panel

*To obtain copies or learn more about the ACCF please contact the Forum Secretary, Caroline Das-Monfrais at the CBI [caroline.dasmonfrais@cbi.org.uk](mailto:caroline.dasmonfrais@cbi.org.uk)*

## Executive summary

<b>The UK governance regime</b>	The UK governance regime for non-financial companies is, by and large, working in the manner intended.
<b>The need for change</b>	The banking crisis and the recession it triggered have damaged public confidence in the corporate sector. There is an acceptance that changes need to be seen to take place, although it is not clear what changes are appropriate.
<b>Consultation on the Combined Code</b>	<p>The ongoing consultation on changes to the Combined Code was discussed. The Walker recommendations are addressed specifically to banks and financial institutions, and it would not be appropriate for them to spill over into the corporate world as a whole.</p> <p>A suggested change from ‘Comply or Explain’ to ‘Apply or Explain’ was seen as positive. However, there will remain problems with investors who automatically regard the ‘explain’ route as a failure of governance.</p> <p>The composition of the board, and the skills and experience of its independent directors (IDs), should reflect the needs and context of the company, rather than being prescribed by regulation.</p> <p>It was considered that there is no need for a requirement to specify a minimum time commitment for IDs.</p> <p>The current assumption that non-executives are not ‘independent’ after nine years is not appropriate to all companies.</p> <p>It would be appropriate for company chairmen to face annual re-election to the board.</p> <p>Board evaluation is useful, but there is a danger of its form becoming too prescribed.</p>
<b>The role of investors in corporate governance</b>	<p>Changes in capital markets and the nature of the investing institutions could have an impact on the way in which corporate governance is conducted in the UK.</p> <p>Engagement with institutional investors is not always simple. Different approaches are taken by their investor teams and their governance teams.</p>
<b>The increasing level of published disclosures</b>	It seems probable that any changes to the Combined Code will result in an increase in companies’ published disclosures. The value of some current disclosures was queried.





# Contents

Executive summary	1
Introduction	2
A need for change?	3
The outlook for change: Walker and the Code	4
Apply or Explain	5
Boards and directors	6
The composition of the board	6
Risk management and the board	7
Board evaluation	8
Staying on the board	9
Tenure	9
Re-election	9
Executive remuneration	10
The role of the investor	11
The value of disclosure	12
Conclusions	13
Appendix 1	
Relevant Recommendations from the Walker Review,	14
Appendix 2	
Review of the Effectiveness of the Combined Code	16
Appendix 3	
Review of the Effectiveness of the Combined Code: Feedback	18

## Introduction

This paper reflects the discussions at a meeting of the Audit Committee Chair Forum (ACCF) held on 24th September 2009, which was addressed by Mr Peter Williams. Mr Williams is chair of the Investor Relations and Markets Committee of The Hundred Group, which represents the finance directors of the 100 largest publicly-traded companies in the United Kingdom.

The meeting was attended by nine chairs of the audit committees of leading companies, a representative of one of the major accounting bodies, a representative of the CBI, and two partners and a director from Ernst & Young.

Mr Williams addressed his opening comments to recent and proposed changes in the UK governance regime, which led to a lively discussion.



## A need for change?

*“We don’t think Corporate Governance is broken.” (PW)*

*“If nothing changes, nobody will be satisfied.”<sup>1</sup>*

The financial crisis has led to a recession, and resulted in a lack of confidence in the corporate world; this cannot be denied. However, the general view of the meeting was that it was directly the result of a failure of the banking and financial services sectors: the non-financial sectors have stood up reasonably well, and their governance processes have not been found to be inadequate. Accordingly, there was a strong feeling that although there are areas where the system should be altered or improved, wholesale change would be counter-productive.

Nevertheless, it was appreciated that some change is inevitable. The legitimacy of UK plc is granted, ultimately, by politicians, the media and the public. The banking crisis, the furore over executive remuneration, and individual cases such as that of the Phoenix Four have led to a widely-held mistrust of the system. Even if those within it are satisfied with its strengths, those outside need overt reassurance - “Something is going to need to be seen to be done.”

---

<sup>1</sup> Quotes that not are attributed were made by audit committee chairs.

## The outlook for change: Walker and the Code

*“The Walker recommendations may be suitable for banks, but that doesn’t necessarily mean they are good for the rest of UK corporates as a whole.”  
(PW)*

Two significant reviews will impact on corporate governance in the UK. The first is the Walker Review, which looked at governance in banks and other financial institutions. Initiated in February 2009; its first consultation paper was issued in July. A summary of its recommendations relevant to this ACCF meeting is attached at Appendix 1.

Concurrent with the Walker Review, the Financial Reporting Council (FRC) conducted a review of the Combined Code. This review was done rather earlier than would normally have been the case: the overlaps in terms of reference with Walker meant that it was appropriate for the two to be conducted in parallel. That way, it was hoped that banking solutions could be found for banking problems without affecting the rest of the governance regime<sup>2</sup>. The questions asked in the review of the Code are set out in Appendix 2 to this report, and its preliminary feedback is summarised at Appendix 3.

Those potential governance changes discussed in the ACCF meeting are set out in the rest of this paper.

---

<sup>2</sup> See the Report of the ACCF meeting held on 19th March 2009 – A Conversation with a Regulator





## Apply or Explain

*“It’s not a battle you need to initiate with the box-tickers and scribblers.”*

The ‘comply or explain’ approach to corporate governance, introduced by the widely-acclaimed Cadbury report in 1992, has proved successful and has been adopted around the world. Nevertheless, there is growing support for this wording to be amended.

The problem expressed by all at the meeting, which has been a regular theme at other ACCF discussions, is that many of the institutional investors and their representative bodies appear to regard ‘comply’ as the sole correct behaviour, and any attempt to ‘explain’ is seen as a failure of corporate governance. Accordingly, it was felt that all explanations by individual boards of why they have adapted their governance to reflect their own circumstances, will attract criticism. Such criticism is often conducted through the media, to the detriment of the company and, arguably, its shareholders. ACCF members identified instances where a desire to avoid such censure had led to a non-optimal approach being adopted in conducting the board’s affairs.

Many of the responses to the FRC’s review of the Code have suggested a move to an ‘apply or explain’ approach. Whilst broadly the same, this subtle change is regarded as likely to encourage a more thoughtful and flexible approach from the institutions: unlike ‘comply’, the word ‘apply’ does not imply a regulatory imperative. This change of wording was favoured by the ACCF meeting.

# Boards and directors

*“It’s all about the chemistry of how the board fits together.” (PW)*

## The composition of the board

*“But if you spend more time ... real danger is that you get too involved in the operational issues and there is a danger of compromising your independence.”*

There was considerable discussion about the need to have relevant skills and experience within the body of independent directors, to enable them to make constructive challenges to the executives. It was accepted that such expertise is important within banking and financial services. However, outside those sectors, the view generally was that companies choose experienced and appropriate individuals to join their boards, and such individuals, whilst not experts in the specific industries, are experienced in board process. It is possible to be a challenging director without direct industry expertise. Furthermore, the need for more specific skills was increasing the size of boards, making them potentially less effective and reducing still further the number of board executives. This was not seen as a particularly good direction to take governance.

Related to this, there was a lot of comment about the Walker proposals for a minimum ‘contracted’ amount of time an independent director should spend on the company. Generally, the meeting felt that sufficient time was being spent by IDs, and that increasing the time commitment could lead them into a more executive rather than an overview role, which was not desirable. It was also noted that increasing the formal time commitment would exclude from the non executive pool those individuals who have other commitments, such as CEOs and CFOs of other companies.

(Having made this point, there was support for a suggestion than in their first year, independent directors should double the time they spend with the company, to get a much more thorough induction and enable them to contribute more quickly.)

This discussion went on more widely to consider the unitary board structure within the UK, and noted that, as the numbers of independent directors rise and their responsibilities increase, in practice, this is sometimes looking like a two-tier structure.

Fundamentally, corporate governance is not a matter of making sure the relevant boxes are ticked, and following all the detailed rules for membership will not ensure an effective team of directors. This is a behavioural issue, about the culture of the company and the board. As such, the role of the chairman of the board is fundamentally important. There was some discussion about the chairman’s role and that of the senior independent director (SID). To many, the role of the SID and the value added by the position were unclear.



## Risk management and the board

*“To hive off risk into some sort of risk committee seems to be a dereliction of the duties of the board.”*

As part of the discussion on the composition and duties of the board, the issue arose of where responsibilities lie for considering business risks.

This is a perennial issue for the ACCF and has been visited at several meetings<sup>3</sup>: there is no one configuration of such board responsibilities that fits all companies. In some, the audit committee is responsible just for financial risk, with a risk committee (often an executive committee) taking the lead as regards more general risks. Other companies have the audit committee overseeing all risk, or have a separate risk committee reporting into the audit committee. Others again have two board committees, but with the audit committee chair sitting as a member of both.

---

<sup>3</sup> For example, the ACCF meeting held on 10th July 2007 - *The Role of the Audit Committee in Risk Management*.

## Board evaluation

*“How do you let the community know that you have actually made step-changes in what you are doing?” (EY)*

The 2003 Combined Code introduced a requirement for “formal and rigorous” annual evaluation of the board and its committees.

The meeting agreed that board evaluation can produce good results, beneficial to the company, if done properly. However, proposals which potentially standardise the way in which evaluations are done will restrict the freedom of companies to tailor the work to their own needs, and could diminish their usefulness.

The view was expressed that companies’ governance reports often fail to explain clearly how they carry out their evaluations, and the benefits. Disclosures now are often just ‘boilerplate’; this should be removed and the quality of disclosure could and should be improved, for the benefit of the company as well as the readers.



## Staying on the board

*“On the whole, it’s a bit more difficult to get people off [the board] than to bring them on.”*

### Tenure

The Combined Code states that non executives who serve more than nine years are no longer considered to be independent. This almost always leads to them having to leave the board. There was much discussion about whether this provision was a good one. Views were expressed both for and against.

Three arguments were made for relaxing this requirement. Firstly, individuals can retain their independence of mind over a longer period. Secondly, it can be to the company’s benefit to retain a particular individual on the board. And finally, shareholders always have the ability to remove a director from the board, either by voting under the standard rotational provisions, or, in particular circumstances, by direct pressure.

However, the alternate view was also strongly represented. This was that it is good to refresh a board, and that any particular individual who was felt to be essential could be retained, under ‘comply or explain’.

### Re-election

Proposals have been aired for each director on a board to face re-election annually, rather than the more customary three year terms adopted by many boards. This was seen as being unnecessary. Indeed, for executives on the board it could lead to difficulties in running the company and problems in succession planning.

A different view was taken as regards the chairman of the board. It was broadly agreed that annual re-election for this office was appropriate, as the chairman is responsible for the whole board. Also, a view was expressed that the chairman’s term should normally not be any longer than six years, to prevent them getting stale in this demanding role.

## Executive remuneration

A brief discussion took place about the various proposed changes to executive remuneration practices<sup>4</sup>. It was generally agreed that it is appropriate to link pay to risk, and to a longer time period. However, the practicalities of clawback were considered challenging.

There should be liaison between the remuneration committee and the audit committee. If there is a risk committee, this too should have an input into or an awareness of the discussions.

---

<sup>4</sup> In addition to the Walker Review, these include the House of Commons Treasury Select Committee report on the banking crisis, and the European Commission Recommendations on executive pay.



## The role of the investor

*“The Code is meant to be a bridge over the agency problem between the owners and the managers. It requires the owners to behave in a certain way for that bridge to be effective.”*

*“We are disappointed with the shareholders.”*

The philosophy of corporate governance in the UK developed in an environment where a majority of shares were held by large financial institutions, often situated in close geographic proximity to each other. Many influential individuals holding long-term investing positions knew each other, and worked together. In such circumstances, principles-based regulation which required active participation could work well. However, capital has become significantly more mobile; shareholders often act as traders rather than owners; and a significant proportion of UK plc is held by foreign institutions. Overall, it is felt that this has led to less engagement by shareholders.

For UK governance to work well, there needs to be engagement from both sides. In recent months Lord Myners, HM Treasury’s Financial Services Secretary, has made several suggestions about how institutional shareholders could and should become more involved in the governance of companies. The FRC’s progress report on the review of the Combined Code also addresses this issue.

The ACCF meeting noted the frustrations of dealing with institutional investors where the investing arm has no interest in the governance aspects, and the compliance arm does not interact with the investment side. With such a split, it is easy to see how a box-ticking mentality can arise, which reduces the value of thoughtful governance.

However, it was noted that shareholders do vote more actively than they used to.

The private equity model of ownership was also discussed, where there is little liquidity for shareholders, and a different form of governance with more engagement from the owners. The model of ownership for alternative investments has less of an agency problem than the traditional market relationship, and it was considered possible that this model may become more prevalent.

## The value of disclosure

*“It costs us far more to put together some of the unbelievably intricate disclosures in the back end of the financial accounts – about which we’ve equally never had a single comment.” (PW)*

The level and complexity of governance disclosures is increasing, not necessarily to the benefit of the users. Although such disclosures are not the most time-consuming element of putting together the annual report, their value was queried. With the exception of the directors’ remuneration report, which does attract comment, none of those present could remember ever having had a question from institutional investors or at the AGM about any of the governance disclosures in the annual report. They neither aid the running of the business nor increase its share price.

The feeling of the meeting was that although the act of disclosing does address some issues of accountability, the boilerplate nature of many disclosures does little for transparency.





## Conclusions

*“[I am] concerned that FRC will feel it necessary to come up with a political solution, not a reasonable solution.”*

The governance regime is changing in response to a changed environment and perception. Although some of these changes were seen as potentially positive, there was a worry that there would be “...more regulation; more disclosures; more oversight and inspection”. A common concern was that this increase in the regulatory burden would stifle corporate activity without actually improving governance and accountability. It was feared that too much new regulation would be counter-productive, and the only increased output would be that of the box-tickers.

## Appendix 1

# Relevant Recommendations from the Walker Review

The Table below summarises those Walker Review recommendations that were touched upon at the ACCF meeting. It does not include all of the Review's 39 recommendations.

<b>Board size, composition and qualification</b>	NEDs on BOFI <sup>5</sup> boards should be expected to give greater time commitment than has been normal in the past. The Review suggests a minimum expected time commitment of 30 to 36 days for the board of a major bank.
	The balance of the board should enable them to have an appropriate level of knowledge and understanding as required to equip them to engage proactively in board deliberation, above all on risk strategy.
<b>Functioning of the board; the roles of the NED and the chairman; and evaluation of board performance</b>	NEDs should be ready, able and encouraged to challenge and test proposals on strategy put forward by the executive. They should satisfy themselves that board discussion and decision-taking on risk matters is based on accurate and appropriately comprehensive information.
	The chairman should be expected to commit a substantial proportion of his or her time, probably not less than two-thirds, to the business of the entity.
	The chairman of a BOFI board should be proposed for election on an annual basis.
	The role of the senior independent director (SID) should be to provide a sounding board for the chairman, for the evaluation of the chairman and to serve as a trusted intermediary for the NEDs as and when necessary. The SID should be accessible to shareholders in the event that communication with the chairman becomes difficult or inappropriate.
	The board should undertake a formal and rigorous evaluation of its performance with external facilitation of the process every second or third year. The statement on this evaluation should be a separate section of the annual report describing the work of the board, the nomination or corporate governance committee as appropriate.
<b>The role of institutional shareholders: communication and engagement</b>	The present best practice “Statement of Principles – the Responsibilities of Institutional Shareholders and Agents” should be ratified by the FRC and become the core of the Principles for Stewardship. Fund managers and other institutions authorised by the FSA to undertake investment business should signify on their websites their commitment to the Principles for Stewardship.

<sup>5</sup> BOFI - Banks and Other Financial Institutions

Governance of risk	The board of a BOFI should establish a board risk committee separately from the audit committee with responsibility for oversight and advice to the board on the current risk exposures of the entity and future risk strategy.
	The board risk report should be included as a separate report within the annual report and accounts.
Remuneration	The remit of the remuneration committee should be extended where necessary to cover all aspects of remuneration policy on a firm-wide basis with particular emphasis on the risk dimension.
	Deferral of incentive payments should provide the primary risk adjustment mechanism to align rewards with sustainable performance for executive board members and 'high-end' executives.
	Incentives should be balanced so that at least one-half of variable remuneration offered in respect of a financial year is in the form of a long-term incentive scheme with vesting subject to a performance condition with half of the award vesting after not less than three years and of the remainder after five years.
	Clawback should be used as the means to reclaim amounts in limited circumstances of misstatement and misconduct.
	Executive board members and 'high-end' executives should be expected to maintain a shareholding or retain a portion of vested awards in an amount at least equal to their total compensation on a historic or expected basis, to be built up over a period at the discretion of the remuneration committee.
	If the non-binding resolution on a remuneration committee report attracts less than 75 per cent of the total votes cast, the chairman of the committee should stand for re-election in the following year irrespective of his or her normal appointment term.

Source: *A Review Of Corporate Governance In UK Banks And Other Financial Industry Entities*, Sir David Walker, 16 June 2009.

## Appendix 2

# Review of the Effectiveness of the Combined Code

In March 2009, the Financial Reporting Council began a periodic review of the Combined Code. Below are set out the questions that were asked (with original paragraph numbering).

### Issues for comment

10. The FRC would welcome views on both the content of the Combined Code and the way that it has been applied by companies and enforced by investors using the 'comply or explain' mechanism.

11. The Combined Code consists of high-level principles and more detailed provisions. While boards are expected to apply the principles, 'comply or explain' allows them a degree of flexibility in choosing whether to follow the Code's individual provisions. Bearing this in mind, views are 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? Views are invited on the usefulness of company disclosures and the quantity and quality of engagement by investors.

### Content of the Code

12. 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;
- The respective roles of the chairman, the executive leadership of the company and the non-executive directors;
- The board's role in relation to risk management;
- The role of the remuneration committee;
- The quality of support and information available to the board and its committees; and
- 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.



## Application of the Code

13. The ‘comply or explain’ approach has a number of theoretical advantages over traditional regulation: it allows boards a degree of flexibility in designing their governance arrangements, and it enables shareholders to judge whether those arrangements will make it more likely that the board will act in their long-term interest.

14. In order to be effective it requires boards to provide investors with the necessary information on which to make that judgement, in particular where they have chosen not to follow the Combined Code; and it requires a sufficient number of investors to take a long-term view and to engage constructively with the companies in which they invest through dialogue and the use of their voting and other rights.

15. The 2007 review found that, while the ‘comply or explain’ approach was felt to be working reasonably well, there were some concerns on both counts. The FRC would be interested to know whether those concerns have increased or decreased in the intervening period and, if they still remain, whether there are steps that could be taken by the FRC or others to increase the usefulness of disclosures and the effectiveness of engagement.

Source: *Review Of The Effectiveness Of The Combined Code: Call for Evidence*. Financial Reporting Council, March 2009

## Appendix 3

# Review of the Effectiveness of the Combined Code: Feedback

In March 2009, the Financial Reporting Council began a periodic review of the Combined Code. In July 2009 it published its summary of the responses to date from that consultation. The summary of those responses is set out verbatim below.


### Summary of feedback to date

The FRC believes that the strength of the response means that what we have heard can reasonably be assumed to be representative of the view of market participants as a whole. That view can be summarised as:

- The Combined Code and its predecessors have contributed to clear improvements in governance standards since the first code was introduced in 1992;
- While there are differing views about the extent to which the perceived shortcomings in governance in the banking sector are replicated in the listed sector as a whole, many consider at least some of them to be specific to that sector;
- There is a recognition that the quality of corporate governance ultimately depends on behaviour not process, with the result that there is a limit to the extent to which any regulatory framework can deliver good governance; and
- Market participants have expressed a strong preference for retaining the current approach of ‘soft law’ underpinned by some regulation, rather than moving to one more reliant on legislation and regulation. It is seen as better able to react to developments in best practice, and because it can take account of the different circumstances in which companies operate it can set higher standards to which they are encouraged to aspire.

While the view of a large majority of respondents was that there is no need for a complete overhaul of the content of the Combined Code, there are a number of parts of the Code which need further review and possibly revision. These are addressed in Section 1 of this report.

Both companies and investors have expressed reservations about the way in which “comply or explain” works in practice, and it is clear that more needs to be done to encourage all parties to apply it in the intended manner. These issues are addressed in Section 2 of the report.



The FRC shares the market's view that the flexible 'soft law' approach remains the most appropriate way of raising standards of corporate governance in listed companies, as does Sir David Walker in his recent consultation paper. But the continuing credibility of this approach depends on there being consensus that the contents of the Code are conducive to best practice, and on companies and investors acting in the spirit, not just the letter, of the Code and "comply or explain".

In particular it is of critical importance that there are sufficient institutional investors willing and able to engage actively with the companies in which they invest. This cannot be taken for granted – dispersed ownership, the declining market share of UK insurance companies and pension funds and resource constraints are all potential obstacles to achieving this objective. In their turn, companies must be willing to welcome communication with their shareholders as an opportunity to obtain an informed external perspective on their performance.

### Next steps

The FRC is not making any specific proposals to amend the Code or enhance "comply or explain" at this stage. If it is concluded that any such changes would be appropriate, these will be subject to separate consultation later in the year.

The FRC aims to publish its final report, and begin consultation on whatever changes may be proposed to the Combined Code, before the end of the year. Subject to the outcome of that consultation, a revised Code would take effect in mid-2010.

Source: *Review Of The Effectiveness Of The Combined Code: Progress report and second consultation*. Financial Reporting Council, July 2009



This document has been printed on recycled paper.