ACCA

REVIEW OF THE EFFECTIVENESS OF THE COMBINED CODE ON CORPORATE GOVERNANCE SECOND CONSULTATION

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Comments from ACCA
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Executive Summary

ACCA welcomes the opportunity to provide further comments on the Review of the Combined Code. Since we made our submission to you in May, we have been able to reflect on those made by others and on recent developments. We were particularly interested in the comments from investors as we see their role as fundamental to ensuring good corporate governance.

The improvements in corporate governance practices that we consider are necessary are dependent not so much on procedures and structures as on achieving changes in corporate values and individuals' behaviour. The FRC needs to consider how these issues can best be integrated into the Code.

The Combined Code should make reference to the duties of directors as set out in S172 of the Companies Act.

The right kind of behaviour might be better encouraged if regulators, investors and companies paid more attention to how good governance principles, particularly Principle 1 of the Combined Code and its supporting principles, are being applied by both companies and investors. This would require both greater awareness of the importance of the principles and fuller and more informative disclosure of how these principles are applied.

There needs to be a better understanding of which generally accepted tenets of good corporate governance 'work' and which others do not. The FRC should lead a project to understand the key drivers of board and investor behaviour in relation to key corporate governance issues.

The assumption which underpins the Code, namely that corporate governance guidance will ultimately be enforced by shareholders, now seems misconceived, since shareholders rarely have the power, motivation or co-ordination to do this to an effective extent. We support efforts to encourage enhanced levels of involvement on the part of shareholders and other stakeholders but consider that their involvement can never guarantee compliance. We therefore believe that steps should be taken to consider whether it is necessary to make some of the Code's provisions mandatory.

General Remarks

The root causes of the crisis in the banking sector may still not be fully understood and it is clear from the submissions made that opinions differ about the extent that failings in corporate governance contributed to it. ACCA is still of the view that governance failures were a major factor. But the governance problem lies more fundamentally with inappropriate values and behaviours at senior levels than with problematic governance structures or deficiencies in rules or governance code. Nevertheless the discretionary character of the Combined Code provides too much leeway for inappropriate values and behaviours to flourish. The challenge therefore is how to make the existing governance regime, and the Code in particular, more effective in ensuring sound values and behaviours.

In Annex 1, we include an extract from ACCA's Corporate Governance and Risk Management Agenda. It sets out ACCA's views on the purpose of corporate governance and 10 principles which we believe are fundamental to all systems of corporate governance that aspire to being the benchmark of good practice.

The importance of principles and doing the right thing
It is widely agreed that the Code principles are more important than the provisions. The practice however has been for companies, investors and their advisors to place more emphasis on the provisions – possibly because the provisions lend themselves to a tick-box approach and so are easy to monitor.

We agree with comments in many of the submissions that the Combined Code principles are sound. ACCA supports them and, as we have suggested repeatedly in our responses to previous consultations on the Code, would like to see more attention paid to them. We commend the suggestion, made by Hermes, that the Code's tone should do more to highlight the importance of good governance to a company's health and encourage the link to good company performance. We also agree that more attention should be paid to improving the quality of disclosure, particularly in relation to the Code principles.

Like Hermes, we were pleased that the Code Preamble in the 2008 Code now states the purpose of good governance, something we have requested in the past. We were disappointed, though, to note the lack of alignment between the Preamble in the 2008 Code and the FSA Listing Rule requirements regarding reporting how companies have applied Code principles.

Listing Rule 9.8.6 (5) requires *'a statement of how the listed company has applied the principles set out in Section 1 of the Combined Code, in a manner that would enable shareholders to evaluate how the principles have been applied*'. The 2006 Combined Code said that this should cover both the main and the supporting principles. The 2008 Code seems (wrongly in our view) to have interpreted the Listing Rule as applying only to the main principles.

An opportunity for boards to demonstrate effectively how they make good governance work for the benefit of companies and investors has therefore been taken away. It means for example that, in relation to the first principle '*A1 Every company should be headed by an effective board, which is collectively responsible for the success of the company'*, the 2008 Code no longer requires disclosure of such important matters contained in the supporting principles as how the board sets its values and standards or how non-executive directors scrutinise the performance of management.

These matters go to the heart of the governance failures in some of the banks. Aviva points out that the only reference to ethics or integrity in the Code is this mention of values and standards in the supporting principle to A1. We agree with their submission that '*greater focus on 'doing the right thing' and developing such a culture would help resolve some fundamental problems at companies'*. We urge the FRC to take a lead in providing such focus.

Questioning the tenets of governance

It is unfortunate that there is little science or theory underpinning the generally accepted principles of corporate governance. The financial crisis has highlighted failings in our present corporate governance system. As far as much of the banking sector is concerned, reforms after Enron and WorldCom have not improved risk management, have not ensured that NEDs provided the necessary challenge or that shareholders hold boards to account.

We must question these tenets; what is needed is a more analytical approach to understanding what works, what does not work and why. It is important to know what the governance system would look like when it is fixed. This requires a willingness to take a fresh look at governance rather than the incremental approach which has characterised code development post Cadbury. We would like the FRC to lead a new initiative to gain greater understanding of the drivers of behaviours in relation to key governance issues such as (a) why non-executive directors did not, or could not, provide more effective challenge and (b) why shareholders did not hold boards sufficiently to account before things went wrong.

Taking stakeholders into account
In ACCA's discussion paper 'Corporate Governance and the Credit Crunch', we discussed the role that banks play in society and highlighted their boards' duties under the Companies Act 2006. Section 172 confers on directors a duty to promote the success of the company and, in the course of making their decisions to that end, they are now required by law to 'have regard' to the following:

I. The likely consequences of any decision in the long term.
II. The interests of the company's employees.
III. The need to foster the company's business relationships with suppliers, customers and others.
IV. The impact of the company's operations on the community and the environment.
V. The desirability of the company maintaining a reputation for high standards of business conduct.
VI. The need to act fairly as between members of the company.

These duties apply to all companies, hence all boards would be wise think long term and to heed the interests of a wider range of stakeholders than only the shareholders. The extent to which boards pay attention to these duties, however, is not clear. Without doubt insufficient regard has been paid by some bank boards to some of these points. It must be helpful if greater attention were paid by boards and investors to these duties. We would like to see reference in the Code to these duties, Principle A1 and its supporting principles would flow from them.

Enforcing good corporate governance

The UK approach to corporate governance is predicated on the assumption that shareholders provide sufficient influence over boards to ensure good governance. Recent events have demonstrated that such an assumption cannot always be justified. While shareholders have some influence, particularly in terms of compliance with Combined Code provisions, shareholders did not enforce good governance behaviour at banks which later needed rescue.

Culture, as well as monitoring and enforcement, determines the extent to which principles are observed and the truth is that the culture has not been supportive. Many in financial institutions may wish to be able to continue as before. In the absence of an effective system of enforcement, or anything else to bring about the required culture change, a system based on principles and provisions allows too much wriggle room for people to do as they like.

We are concerned that shareholders may be structurally unable to enforce good governance. In society we have laws for where we cannot trust the behaviours of people left to their own devices. We hope that culture will change sufficiently to ensure a healthy system of governance based on principles and provisions but experience has shown that it is necessary to have a corporate governance system with more bite.

Greater emphasis by all those interested in good governance (including the FSA, the FRC, companies and investors) on the governance principles might help to bring about the needed changes in values and behaviours. Such emphasis may, alas, not be sufficient and ACCA argued in its May response to the Combined Code consultation that a project should be instigated to identify whether any provisions of the Code should be made mandatory.

The Walker Review

In our response to the Walker Review we expressed doubt as to whether its recommendations will have the influence over behaviour which is required. One of our concerns was that it would be possible to take achieve ticks in a lot of boxes without demonstrating good governance. If it were the substance of the recommendations, and not just their form, that were implemented, we would be supportive of much of the Review and its conclusions.

ACCA's response to the first FRC consultation
ACCA submitted a detailed response in May to the first FRC consultation on the Code this year. We trust the FRC will take this into account when assessing all the evidence gathered.

Answers to Specific Issues for Further Consideration Listed in the Second Consultation

The responsibilities of the chairman and the non-executive directors
The lack of constructive challenge in the boardroom is clearly a serious issue which needs to be addressed. As explained above, we urge the FRC to take a lead in providing greater focus on 'doing the right thing', as developing such a culture would help resolve some fundamental problems at companies.

Board balance and composition
There is clearly a need for greater diversity in the boardroom. What is important is to have a board that can govern a company successfully and within that board to have people who do not suffer from group think, who think for themselves and who have the experience, inclination and courage to ask searching questions.

ACCA has maintained that independence of mind for directors is more important than independence in appearance. We have not been supportive of the 'nine year rule' for independent directors. While agree that a balance of executive and non-executive directors is desirable, we have previously expressed concern about the need for at least 50% of the board to be independent as it could mean fewer executive directors and poorer discussion and decision making.

Frequency of director re-election
We are sympathetic to the idea there should be more frequent opportunities for re-election of the chairman and directors. We are concerned, however, that annual re-election could exacerbate short term thinking if a consequence is that board members focus on re-election to the detriment of running the company.

Board information, development and support
We support the Walker recommendation on training and induction and called for something similar in our recommendation 2 in our May response to the FRC.

Similarly we support the Walker recommendation about NEDs being able to require advice independent of management and called for this in our recommendation 1 in our May response. In recommendation 1 we also said the Code should empower all board committees to take outside advice at the company's expense.

A common feature of corporate governance debacles has been that boards were taken by surprise by events. We agree with Walker that the chairman should be responsible for ensuring that directors receive accurate and timely information. It is crucial that NEDs are neither kept in the dark by executives nor so taken by surprise.

Board evaluation
We consider it is highly desirable for boards and committees to undertake a proper evaluation process. Too often though, participants do not value the process and it becomes a compliance routine which adds no value. The commitment of the chairman to the process is essential and external facilitation is desirable. The idea of an assurance statement has merit and could be achieved by boards stating how they apply all the Code principles, including supporting principles.

Risk management and internal control
There should be a joined up, rather than piecemeal, approach to reporting on risk and risk management. ACCA has previously suggested that the disclosures of Turnbull compliance statements and statements on actual risks to the business required in the Business Review should be located in one place. It would be useful to see more disclosure about a company's risk appetite and not simply a statement that it is the board's responsibility.

We have made a number of other suggestions about risk management in our May response.

Remuneration
We would support a project by the FRC to consider changes to the Code to improve practice and give shareholders a more direct role. We were disappointed when much of the guidance on remuneration in the Hampel Code disappeared from the Combined Code after remuneration provisions became law.

The quality of disclosure by companies
We have set out our views on disclosure in our general comments (above). We believe the FRC could do more to improve disclosure of how companies apply the Code principles.

Engagement between boards and shareholders
One of the great weaknesses of our current governance system is that investors (and those with a beneficial interest in investment vehicles) seem unable to provide sufficiently robust enforcement of good governance. We believe the reasons for this are many and complex but chief among them is that shareholder rights are not strong except with regard to the generally very risky 'Exocet' option of declining to re-elect directors. We recommend the FRC launches a project to understand better the reasons for the problem and consults on the options for improvement. As we suggested in our May response, there may be a need for making certain governance matters mandatory if enforcement by shareholders is not practicable. We also suggested that there should be a requirement for shareholders to approve deviations from the Combined Code.

We are sympathetic to the idea expressed, in several submissions, for a separate code for institutions that manage assets.

Annex 1 Extract of ACCA's Corporate Governance and Risk Management Agenda

A. The purpose of corporate governance
Fundamental to this Agenda is ACCA's view of the purpose of corporate governance. Our research suggests there is a divergence of view: some see corporate governance as improving effectiveness, some see it as protecting stakeholders while, unfortunately, a number regard corporate governance as a compliance exercise with little intrinsic value.

ACCA's view is that there are three complementary main purposes of corporate governance.

1. To ensure the board, as representatives of the • organisation's owners, protects resources and allocates them to make planned progress towards the organisation's defined purpose.
2. To ensure those governing and managing an • organisation account appropriately to its stakeholders.
3. To ensure shareholders and, where appropriate, other • stakeholders can and do hold boards to account.

We use the word 'appropriate' as clearly not all stakeholder groups have equal rights or responsibilities. These different rights and responsibilities will be addressed in ACCA's policy positions on specific sectors.

Although none of the above purposes refer explicitly to it, we regard effective risk management as fundamental to good corporate governance.

B. ACCA's Corporate Governance and Risk Management Principles
The principles set out below are matters that ACCA believes are fundamental to all systems of corporate governance that aspire to being the benchmark of good practice. They are intended to be relevant to all sectors globally, and to any organisation having a significant degree of separation between ownership and control. Many of these principles are also relevant to organisations where ownership and control lie with the same people.

1. Boards, shareholders and stakeholders share a common understanding of the purpose and scope of corporate governance
There should be a clear understanding of what corporate governance is for. ACCA's view is stated in section A above.

2. Boards lead by example
Boards should set the right tone and behave accordingly, paying particular attention to ensuring the continuing ethical health of their organisations. Directors should regard one of their responsibilities as being guardians of the corporate conscience; non-executive directors should have a particular role in this respect. Boards should ensure they have appropriate procedures for monitoring their organisation's 'ethical health'.

3. Boards appropriately empower executive management and committees
Boards should set clear goals, accountabilities, appropriate structures and committees, delegated authorities and policies. They should provide sufficient resources to enable executive management to achieve the goals of the organisation through effective management of day-to-day operations, and monitor management's progress towards the achievement of these goals.

4. Boards ensure their strategy actively considers both risk and reward over time
All organisations face risk: success in achieving their strategic objectives will usually require understanding, accepting, managing and taking risks. Consideration of risk should therefore be a key part of strategy formulation. Risk management should be embedded within organisations so that risk is considered as part of decision making at all levels in the organisation. To avoid creating a risk averse culture, risk should be about both threats and opportunities. Boards need to understand the risks faced by the organisation, satisfy themselves that the level of risk is acceptable and challenge executive management when appropriate.

5. Boards are balanced
Boards should include both outside non-executive and executive members in the governance of organisations. Outside members should challenge the executives but in a supportive way. No single individual should be able to dominate decision making. It follows that the board should work as a team with outside members contributing to strategy rather than simply having a monitoring or policing role. Boards need to comprise of members who possess skills and experience appropriate for the organisation. All board members should endeavour to acquire a level of understanding of financial matters that will enable them to participate in decisions regarding the financial direction and control of the organisation.

6. Executive remuneration promotes organisational performance and is transparent
Remuneration arrangements should be aligned with individual performance in such a way as to promote organisational performance. Inappropriate arrangements, however, can promote perverse incentives that do not properly serve the organisation's shareholders or other principal stakeholders. Disclosures of director and senior executive pay must be sufficiently transparent to enable shareholders or other principal stakeholders to be assured that arrangements are appropriate.

7. The organisation's risk management and control is objectively challenged, independently of line management
Internal and external audit are potentially important sources of objective assessment and assurance. Internal and external audit should be able to operate independently and objectively, free from management influence. Neither internal nor external auditors should subordinate their judgement on professional matters to that of anyone else. A key part of internal and external audit's scope should be assessment of the control environment including such aspects as culture and ethics.

Internal audit should be able to report directly to the board and should be properly resourced with staff of suitable calibre to work effectively at all levels of the organisation including the board.

8. Boards account to shareholders and, where appropriate, other stakeholders for their stewardship

In acting as good stewards, boards should work for the organisation's success. Boards should also appropriately prioritise and balance the interests of the organisation's different stakeholders. In a shareholder owned company, shareholder interests are paramount but their long term interests will be best served by considering the wider interests of society, the environment, employees and other stakeholders as well.

The type of organisation, its ownership structure and the culture within which it operates will determine how boards should account to their owners and/or significant stakeholders. No single model of accountability will be appropriate for all organisations in all regions. A universal requirement, however, is to disclose sufficient, appropriate, clear, balanced, reliable and timely financial and other information to those to whom boards should be accountable. Such information should cover the organisation's objectives, performance, prospects, risks, risk management strategy, internal control and governance practices.

9. Shareholders and other significant stakeholders hold boards to account

Owners and, in some cases, other significant stakeholders need to take an interest in the organisation and hold the board to account for its performance, behaviour and financial results. ACCA recognises that in many societies, the owners of organisations will have to take other stakeholder interests into account. As in Principle 8 above, the mechanisms required to enable this will depend upon the type of organisation, ownership structure and culture.

Toward this end, a fully independent external audit process, overseen by an effective audit committee, is an important component of good governance. The membership of audit committees should have sufficient financial literacy and at least one member should hold an appropriate accountancy qualification.

10. Corporate governance evolves and improves over time

Organisations in different sectors and across the world operate in diverse environments in terms of culture, regulation, legislation and enforcement. What is appropriate, in terms of governance, for one type of organisation will not be appropriate to all organisations.

A voluntary 'comply or explain' approach to governance, which allows organisations flexibility to innovate and improve as well as enabling stakeholder pressure to enforce good governance practice, is preferable to legislation providing it results in satisfactory standards of corporate governance. Legislation is rigid whereas more flexible systems allow innovation and improvement but at the risk of allowing poor practices to continue, particularly if Principle 9 cannot be upheld.

To assist innovation and improvement in corporate governance and in risk management, there should be flexibility in practices and structures. Corporate governance and risk management will never be fully evolved and may always be improved upon. It is important, therefore, that requirements do not create a straightjacket which prevents innovation and improvement in the ways organisations conduct themselves.

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