A REVIEW OF CORPORATE GOVERNANCE IN UK BANKS AND OTHER FINANCIAL INDUSTRY ENTITIES

Issued by Sir David Walker

Comments from ACCA
October 2009

ACCA

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General Remarks

ACCA welcomes the opportunity to provide these comments to the Review and wishes to compliment Sir David Walker in the depth and breadth of the analysis. Unfortunately, we do not think the recommendations quite match the quality of the analysis.

The root cause of governance failings in the banking sector may still not be fully understood. It is probably more associated with inappropriate values and behaviours at senior levels in the banking sector than with problematic governance structures or deficiencies in rules or governance code provisions. We are doubtful whether the Report's recommendations will have the influence over behaviour that is required.

It is now widely accepted that it is dangerous to have banks which are too big to fail. Capitalism needs competition but the recent consolidation in the banking sector now means, in both the USA and UK, that we have banking oligopolies and very limited competition. This may be in the interest of the remaining banks but it is not in the public interest. It is therefore disappointing that the Terms of Reference for this review are so narrow that the report accepts the present uncompetitive structure of banking and that nothing more radical is being proposed.

We agree with the analysis that corporate governance in the UK is a 'somewhat idiosyncratic mix' and one should question whether these 'hybrid arrangements' should be replaced. Attached to this response is ACCA's Corporate Governance Agenda which sets out the purpose of corporate governance and 10 principles which ACCA considers fundamental to good corporate governance and risk management. We believe that if the banking sector had followed these principles, banks would not have failed and the economy would be healthier. We are not sure if anyone can correctly say they understand what corporate governance 'ideal' might be like and Principle 10 of our Agenda recognises that governance should evolve and improve over time.

It is unfortunate that there is little or no science or theory underpinning the present Combined Code or the Walker Report recommendations. The financial crisis has highlighted that our present corporate governance system has been found wanting in a range of circumstances. As far as much of the banking sector is concerned – certainly in the UK and US and certain other jurisdictions, reforms after Enron and WorldCom have not improved risk management, have not ensured that NEDs provided the necessary challenge or that shareholders can hold boards to account. 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.

The UK approach to corporate governance is predicated on the assumption that shareholders can provide sufficient influence over boards to ensure good governance. Recent events have demonstrated that such an assumption cannot be justified. While shareholders have some influence, shareholders did not, and quite possibly are structurally unable to, enforce good governance behaviour.

The 39 recommendations in the Review seem more directed at symptoms of the underlying problem than with effectively addressing the root cause – "done to be seen rather than seen to be done". We are concerned therefore that the recommendations will not significantly improve governance. It is unlikely, for example, that implementation of the recommendations would significantly enhance the ability of shareholders to influence boards without some other trigger to change behaviours.

We suggest taking more of a systems view to the problem. The starting point should be to answer the question 'what do BOFIs do, or should they do?' and then to consider what governance system would help the ability of BOFIs to meet their objectives.

Annex 4 of the Review lists 17 BOFIs. Six of these are banks including three (now two) substantially in public ownership, and a variety of insurers and financial services companies plus the London Stock Exchange. This is a very diverse collection and, with the exception of AIG, the non banking institutions did not play a significant role in the financial crisis. Our remaining points therefore apply only to banks.

Returning to the question of what do banks do or should they do. Recent events highlighted the interdependence of society and the banking system. Society needs a sound banking system and much of the banking system has needed society to refinance it, at significant cost to tax payers. It should be clear therefore that the purpose of banks cannot simply be to make as much money as possible for its executives, traders and shareholders. We therefore disagree with the Review that 'the core objective of a bank or other financial institution is the successful arbitrage of risk'. Surely the core objective of a bank is to take deposits from actual and legal persons, and to make loans available to actual and legal persons? If the banking system is to continue to rely either on actual, or just the promise of, taxpayer support, then banks' purpose must include an ethical responsibility to society; governance systems for banks should aim to ensure this requirement is met.

The UK Combined Code contains both principles and provisions. It is widely agreed amongst corporate governance experts that the principles are the more important. The practice however has been for companies, investors and their advisors to place more emphasis on the provisions, leading inevitably to a tick-box approach, which is easier to monitor.

Companies are supposed to report on how they apply the Code principles. The first main principle and its supporting principles summarise the essence of good corporate governance (reproduced in Annex 1). Insufficient attention has been paid to this principle in the past; in our view, it is the most important part of the Combined Code. Clearly the principle was not successfully put into practice in a number of banks. Governance reform should focus on how best to ensure this principle is practised. The concept of comply or explain applies only to the Code provisions. We suggest that it is more important to apply the Combined Code principles properly (and state how they are applied) than it is to comply or explain. Greater emphasis by regulators, companies and investors on the governance principles would help to bring about the needed changes in values and behaviours.

While we believe strongly in the importance of the Combined Code principles, it is culture which will determine the extent to which they 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 whatever they like.

We expressed the concern 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 it may be necessary to have corporate governance rules that bite. ACCA has argued in its response to the Combined Code consultation (Annex 3) that a project should be instigated to identify which provisions of the Code should be made mandatory, and that shareholder approval should be necessary when any provision is not complied with.

Answers to Specific Questions in the Consultation

We think many of the recommendations will not bring about the required improvements because, if implemented, it would be quite possible for BOFIs to tick the box and comply with the letter of most of them without adhering to their spirit. It is essential to avoid a situation where there is the appearance of reform but no real reform.

It follows from the above that we do not generally support the recommendations as we prefer a different approach focussing on values and behaviour rather than structure. Without more appropriate values and behaviour we consider that more of best practice corporate governance needs to be made mandatory rather than discretionary as at present.

We do however comment on each of the recommendations, on the basis that their substance, not just their form, will be implemented:

Board size, composition and qualification

Recommendation 1
To ensure that NEDs have the knowledge and understanding of the business to enable them to contribute effectively, a BOFI board should provide thematic business awareness sessions on a regular basis and each NED should be provided with a substantive personalised approach to induction, training and development to be reviewed annually with the chairman.

Agreed.

Recommendation 2
A BOFI board should provide for dedicated support for NEDs on any matter relevant to the business on which they require advice separate from or additional to that available in the normal board process.

Agreed.

Recommendation 3
NEDs on BOFI boards should be expected to give greater time commitment than has been normal in the past. A minimum expected time commitment of 30 to 36 days in a major bank board should be clearly indicated in letters of appointment and will in some cases limit the capacity of the NED to retain or assume board responsibilities elsewhere.

We agree that it is desirable for NEDs to give greater time commitment but question whether 30 to 36 days would be sufficient for them to do all which is expected of them.

Recommendation 4
The FSA's ongoing supervisory process should give closer attention to both the overall balance of the board in relation to the risk strategy of the business and take into account not only the relevant experience and other qualities of individual directors but also their access to an induction and development programme to provide an appropriate level of knowledge and understanding as required to equip them to engage proactively in board deliberation, above all on risk strategy.

Agreed. However to do this effectively would require a high level of skill, experience and judgement from FSA staff.

Recommendation 5
The FSA's interview process for NEDs proposed for major BOFI boards should involve questioning and assessment by one or more senior advisers with relevant industry experience at or close to board level of a similarly large and complex entity who might be engaged by the FSA for the purpose, possibly on a part-time panel basis.

Agreed, in theory, but this may be difficult in practice particularly given the current oligopoly in the UK's banking sector.

We agree with the Walker Review analysis that, while it is desirable for some NEDs to have industry experience, there is the risk of group think. We suggest, therefore, it is also desirable to have at least two others from a different background who can provide constructive questioning.

Functioning of the board and evaluation of performance

Recommendation 6
As part of their role as members of the unitary board of a BOFI, 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 and draws, as far as they believe it to be relevant or necessary, on external analysis and input.

Agreed.

Recommendation 7
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, with clear understanding from the outset that, in the event of need, the BOFI chairmanship role would have priority over any other business time commitment.

Agreed.

Recommendation 8
The chairman of a BOFI board should bring a combination of relevant financial industry experience and a track record of successful leadership capability in a significant board position. Where this desirable combination is only incompletely achievable, the board should give particular weight to convincing leadership experience since financial industry experience without established leadership skills is unlikely to suffice.

Agreed, arguably a definition of “financial industry experience” would be useful.

Recommendation 9
The chairman is responsible for leadership of the board, ensuring its effectiveness in all aspects of its role and setting its agenda so that fully adequate time is available for substantive discussion on strategic issues. The chairman should facilitate, encourage and expect the informed and critical contribution of the directors in particular in discussion and decision-taking on matters of risk and strategy and should promote effective communication between executive and non-executive directors. The chairman is responsible for ensuring that the directors receive all information that is relevant to discharge of their obligations in accurate, timely and clear form.

Agreed, but we would like to see more consideration of the nature of relationship between Chair and CEO.

Recommendation 10
The chairman of a BOFI board should be proposed for election on an annual basis.

We agree with the logic of the recommendation but question whether this could exacerbate short term thinking by the board.

Recommendation 11
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.

Agreed.

Recommendation 12
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. Where an external facilitator is used, this should be indicated in the statement, together with an indication whether there is any other business relationship with the company.

We agree that facilitation by someone not on the board with suitable experience and who is an independent and objective party is desirable.

Recommendation 13
The evaluation statement should include such meaningful, high-level information as the board considers necessary to assist shareholders understanding of the main features of the evaluation process. The board should disclose that there is an ongoing process for identifying the skills and experience required to address and challenge adequately the key risks and decisions that confront the board, and for evaluating the contributions and commitment of individual directors. The statement should also provide an indication of the nature and extent of communication by the chairman with major shareholders.

Agreed.

The role of institutional shareholders: communication and engagement

Recommendation 14
Boards should ensure that they are made aware of any material changes in the share register, understand as far as possible the reasons for changes to the register and satisfy themselves that they have taken steps, if any are required, to respond.

Agreed.

Recommendation 15
In the event of substantial change over a short period in a BOFI share register, the FSA should be ready to contact major selling shareholders to understand their motivation and to seek from the BOFI board an indication of whether and how it proposes to respond.

Agreed. Should the FSA publicise information it receives?

Recommendation 16
The remit of the FRC should be explicitly extended to cover the development and encouragement of adherence to principles of best practice in stewardship by institutional investors and fund managers. This new role should be clarified by separating the content of the present Combined Code, which might be described as the Corporate Governance Code, from what might most appropriately be described as Principles for Stewardship.

Recommendation 17
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. By virtue of the independence and authority of the FRC, this transition to sponsorship by the FRC should give materially greater weight to the Principles.

Recommendation 18
The ISC, in close consultation with the FRC as sponsor of the Principles, should review on an annual basis their continuing aptness in the light of experience and make proposals for any appropriate adaptation.

Recommendation 19
Fund managers and other institutions authorised by the FSA to undertake investment business should signify on their websites their commitment to the Principles of Stewardship. Such reporting should confirm that their mandates from life assurance, pension fund and other major clients normally include provisions in support of engagement activity and should describe their policies on engagement and how they seek to discharge the responsibilities that commitment to the Principles entails. Where a fund manager or institutional investor is not ready to commit and to report in this sense, it should provide, similarly on the website, a clear explanation of the reasons for the position it is taking.

Recommendation 20
The FSA should encourage commitment to the Principles of Stewardship as a matter of best practice on the part of all institutions that are authorised to manage assets for others and, as part of the authorisation process, and in the context of feasibility of effective monitoring to require clear disclosure of such commitment on a "comply or explain" basis.

Recommendation 21
To facilitate effective collective engagement, a Memorandum of Understanding should be prepared, initially among major long-only investors, to establish a flexible and informal but agreed approach to issues such as arrangements for leadership of a specific initiative, confidentiality and any conflicts of interest that might arise. Initiative should be taken by the FRC and major UK fund managers and institutional investors to invite potentially interested major foreign institutional investors, such as sovereign wealth funds and public sector pension funds, to commit to the Principles of Stewardship and, as appropriate to the Memorandum of Understanding on collective engagement.

These recommendations could be helpful if there is a mechanism to make such principles bite. The Tomorrow's Company Report 'Restoring Trust – Investment in the 21st Century' written by Sir Richard Sykes in 2004 highlighted numerous challenges to the UK investment system and many of these remain to be addressed. We agree that more productive relationships between boards and shareholders should help directors better manage companies' affairs. We would question, however, whether institutional shareholders can reasonably be expected to steer a company away from a reckless course of action – can they know better than BOFI boards when, say, gearing is too high, risk is not properly managed or the business model is flawed?

Recommendation 22

Voting powers should be exercised, fund managers and other institutional investors should disclose their voting record, and their policies in respect of voting should be described in statements on their websites or in other publicly accessible form.

We agree that voting powers should be exercised. Disclosure of voting records could also be helpful provided it is accompanied by constructive engagement. A tick box response to this recommendation could be that investors vote in accordance with recommendations from one of the advisory consultants without proper consideration of the issues.

Governance of risk

Recommendation 23

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. In preparing advice to the board on its overall risk appetite and tolerance, the board risk committee should take account of the current and prospective macro-economic and financial environment drawing on financial stability assessments such as those published by the Bank of England and other authoritative sources that may be relevant for the risk policies of the firm.

Agreed.

Recommendation 24

In support of board-level risk governance, a BOFI board should be served by a CRO who should participate in the risk management and oversight process at the highest level on an enterprise-wide basis and have a status of total independence from individual business units. Alongside an internal reporting line to the CEO or FD, the CRO should report to the board risk committee, with direct access to the chairman of the committee in the event of need. The tenure and independence of the CRO should be underpinned by a provision that removal from office would require the prior agreement of the board. The remuneration of the CRO should be subject to approval by the chairman or chairman of the board remuneration committee.

Recommendation 25
The board risk committee should have access to and, in the normal course, expect to draw on external input to its work as a means of taking full account of relevant experience elsewhere and in challenging its analysis and assessment.

Recommendation 26
In respect of a proposed strategic transaction involving acquisition or disposal, it should as a matter of good practice be for the board risk committee to oversee a due diligence appraisal of the proposition, drawing on external advice where appropriate and available, before the board takes a decision whether to proceed.

Recommendation 27
The board risk committee (or board) risk report should be included as a separate report within the annual report and accounts. The report should describe the strategy of the entity in a risk management context, including information on the key exposures inherent in the strategy and the associated risk tolerance of the entity and should provide at least high level information on the scope and outcome of the stress-testing programme. An indication should be given of the membership of the committee, of the frequency of its meetings, whether external advice was taken and, if so, its source.

Banks already have separate risk functions which are well staffed. The separation may have contributed to the spurious so-called scientific approach to risk at the expense of common sense which became prevalent in many banks. Risk management should be part of and not separate from the management process.

The analysis in the Review implies the role of the CRO would be one of independent assessment whereas Recommendation 24 refers to 'participation in the risk management'. The recommendations seem to imply a separate risk management function, whereas what is needed is risk management integrated into management decision making AND a separate risk management oversight or assurance function. The establishment of a separate risk management function would be both expensive and counterproductive.

ACCA is strongly of the opinion that boards need an independent risk assurance function capable of providing independent, objective and sound opinion on the organisation's enterprise risk management and systems of internal control.

There should be a communication line from independent assurance function to regulator.

Remuneration

Recommendation 28
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.

Agreed.

Recommendation 29
The terms of reference of the remuneration committee should be extended to oversight of remuneration policy and remuneration packages in respect of all executives for whom total remuneration in the previous year or, given the incentive structure proposed, for the current year exceeds or might be expected to exceed the median compensation of executive board members on the same basis.

Agreed but the extension should include remuneration of highly earning people such as traders not necessarily classed as executives. The report by UBS to its shareholders revealed that staff below executive received bonuses based on high risk transactions which were not in the bank's interest.

Recommendation 30
In relation to executives whose total remuneration is expected to exceed that of the median of executive board members, the remuneration committee report should confirm that the committee is satisfied with the way in which performance objectives are linked to the related compensation structures for this group and explain the principles underlying the performance objectives and the related compensation structure if not in line with those for executive board members.

Agreed but, as above, this should include remuneration of highly earning people such as traders not necessarily classed as executives.

Recommendation 31
The remuneration committee report should disclose for "high end" executives whose total remuneration exceeds the executive board median total remuneration, in bands, indicating numbers of executives in each band and, within each band, the main elements of salary, bonus, long-term award and pension contribution.

Agreed but, as above, this should include remuneration of highly earning people such as traders not necessarily classed as executives.

Recommendation 32
Major FSA-authorised BOFIs that are UK-domiciled subsidiaries of non-resident entities should include in their reporting arrangements with the FSA disclosure of the remuneration of "high end" executives broadly as recommended for UK-listed entities but with detail appropriate to their governance structure and circumstances agreed on a case by case basis with the FSA. Disclosure of "high end" remuneration on the agreed basis should be included in the annual report of the entity that is required to be filed at Companies House.

Agreed but, as above, this should include remuneration of highly earning people such as traders not necessarily classed as executives.

Recommendation 33
Deferral of incentive payments should provide the primary risk adjustment mechanism to align rewards with sustainable performance for executive board members and executives whose remuneration exceeds the median for executive board members. 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. Short-term bonus awards should be paid over a three year period with not more than one-third in the first year. Clawback should be used as the means to reclaim amounts in limited circumstances of misstatement and misconduct.

We agree with the principle of deferral and claw back of incentive payments and recommended this last year. The principle should apply to all who receive incentive payments and/or bonuses in substantial amounts. In practice there may be resistance to claw back, particularly in relation to 'star-traders' who banks may consider need to retained.

Recommendation 34

Executive board members and executives whose total remuneration exceeds that of the median of executive board members 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. Vesting of stock for this group should not normally be accelerated on cessation of employment other than on compassionate grounds.

A high degree of employee share ownership did not help Lehman. We agree that vesting of stock should not normally be accelerated.

Recommendation 35

The remuneration committee should seek advice from the board risk committee on an arm's-length basis on specific risk adjustments to be applied to performance objectives set in the context of incentive packages; in the event of any difference of view, appropriate risk adjustments should be decided by the chairman and NEDs on the board.

Agreed but advice should also be sought from the independent risk assurance function (see our response to recommendations 24 to 27).

Recommendation 36

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.

Agreed

Recommendation 37
The remuneration committee report should state whether any executive board member or senior executive has the right or opportunity to receive enhanced pension benefits beyond those already disclosed and whether the committee has exercised its discretion during the year to enhance pension benefits either generally or for any member of this group.

Agreed

Recommendation 38
The remuneration consultants involved in preparation of the draft code of conduct should form a professional body which would assume ownership of the definitive version of the code when consultation on the present draft is complete. The proposed professional body should provide access to the code through a website with an indication of the consulting firms committed to it; and provide for review and adaptation of the code as required in the light of experience.

Recommendation 39
The code and an indication of those committed to it should also be lodged on the FRC website. In making an advisory appointment, remuneration committees should employ a consultant who has committed to the code.

The recommendations imply that the board of a firm would be unable to recognise what constitutes a risk balanced remuneration package. We are doubtful what difference such a code would make to behaviours beyond consultants pronouncing their commitment to it. A 'professional' body implies the need for it, and its members, to work in the public interest, in contrast to a trade body.

Annex 1: The First Main Principle of the Combined Code

A.1 The Board

Main Principle
Every company should be headed by an effective board, which is collectively responsible for the success of the company.

Supporting Principles
The boards role is to provide entrepreneurial leadership of the company within a framework of prudent and effective controls which enables risk to be assessed and managed. The board should set the company's strategic aims, ensure that the necessary financial and human resources are in place for the company to meet its objectives and review management performance. The board should set the company's values and standards and ensure that its obligations to its shareholders and others are understood and met.

All directors must take decisions objectively in the interests of the company.

As part of their role as members of a unitary board, non-executive directors should constructively challenge and help develop proposals on strategy. Non-executive directors should scrutinise the performance of management in meeting agreed goals and objectives and monitor the reporting of performance. They should satisfy themselves on the integrity of financial information and that financial controls and systems of risk management are robust and defensible. They are responsible for determining appropriate levels of remuneration of executive directors and have a prime role in appointing, and where necessary removing, executive directors, and in succession planning.

Annex 2: 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.

Annex 3: ACCA Response to FRC Consultation on the Combined Code

Chris Hodge
Financial Reporting Council
Aldwych House
LONDON WC2B 4HN

26 May 2009

Dear Chris

REVIEW OF THE EFFECTIVENESS OF THE COMBINED CODE

ACCA is pleased to have this opportunity to participate in the FRC's consultation on its review of the effectiveness of the Combined Code ('the Code'). We note that the FRC is inviting views on both the content of the Code and the way that it has been applied by companies and enforced by investors using the 'comply or explain' mechanism. Our comments in this submission address a number of points about corporate governance practice and incorporate recommendations for change which we invite the Council to consider.

Before addressing the specific issues raised in the consultation paper we would like to make a few points of our own.

THE ROLE OF CORPORATE GOVERNANCE IN THE ECONOMIC CRISIS

While various failures have been blamed for the current economic crisis, ACCA considers that corporate governance failures are chief among them. Regrettably, there are sufficient examples across the sectors for us to conclude that corporate governance in general, not just within financial institutions, has let us down. Fine tuning of the current system will not resolve this problem, since it has not done so in the past. For instance, concerns about executive remuneration have grown since the Greenbury Report (July 1995) gave us our first Code of Best Practice for Executive Remuneration, which was combined into the Hampel Code of 1998.

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FAILURE OF NON-EXECUTIVE DIRECTORS

It was untimely that the two 2007/8 changes to the Code relaxed the Code's provisions on chairing boards (provision A.4.3) and on audit committee membership (C.3.1). Nevertheless we acknowledge that the development of the Code over the years has progressively and considerably enhanced the requirements for and responsibilities of independent directors on UK listed company boards. To draw attention to the failure of independent directors is not to say that less reliance should be placed upon them in the future. But consideration needs to be given to addressing the causes of their ineffectiveness.

While two-tier board structures have not always been notably successful, they can contribute to ensuring that the supervisory board directs and oversees, while the management board manages. In practice, much depends on the composition and powers of the two boards in a two-tier structure.

A common feature of corporate governance debacles has been that boards, especially their non-executive directors, have been taken by surprise by events. ACCA believes this is not unconnected to the ability of, and tendency for, top executives to control the flow of information to the board; and that boards operate in a partial assurance vacuum.

Recommendation 1

It should be mandatory for boards of public interest entities to receive assurance, independent of management, that (a) the policies of the board are being implemented by management and (b) the significant internal and external risks to the company have been identified and are being mitigated. We consider that acceptance of our Recommendations 10 and 15 below could meet the aims of this Recommendation.

Recommendation 2

The Code should be strengthened in its definition of the requisite training, qualifications, time commitment and conduct of non-executive directors.

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Recommendation 3

Compliance with the Code should require cross-directorships to be avoided by all non-executive directors, not just those deemed to be independent.

Recommendation 4

As a first step, the FRC should consider the implications of introducing as an option a two-tier board structure and should consider the changes to the Code that would need to be articulated.

UK PILLARS OF CORPORATE GOVERNANCE INSUFFICIENTLY JOINED-UP OR ROBUST

While we welcome the regular reviews by the FRC of the wording of the Code, the challenge for UK corporate governance is much more fundamental than the wording of the Code: there is a need for the main 'pillars' of UK corporate governance to collectively determine a better route forward. ACCA believes that regulation of corporate governance in the UK is currently so light touch as to have very little impact at all. While we do not suggest that we move to the other extreme, we consider that there is now a clearly demonstrated need for more robust regulation in this area. UK lapses in corporate governance standards incur very modest sanctions compared, for instance, with the US.

The main pillars of UK corporate governance appear to us to be as follows:

(i) The FRC

While the FRC is responsible for the content of the Code, unlike the position with regard to financial reporting, external auditing and actuarial affairs, it has little or no corporate governance enforcement or disciplinary roles.

(ii) The FSA

The FSA refers to the Code in its Listing Rules but regards rule 9.8.6 as merely a disclosure obligation for a listed company, not a listing requirement to apply the Code's principles nor to 'comply or explain' with respect to the Code's 'provisions'.

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(iii) Shareholder bodies

The owners of listed companies, armed with clear disclosures, who have ultimate authority at present to discharge the enforcement role.

(iv) Professional advisers

The professions, especially external auditors, who review clients' assertions of compliance with specified elements of the Code's provisions.

(v) Company law and regulation

The roles of BERR and EC are integral to this.

RELIANCE ON SHAREHOLDERS OF LISTED COMPANIES IS INSUFFICIENT

ACCA believes it will never be sufficiently effective to rely on shareholders and bodies that represent them to enforce high standards of corporate governance by companies, since they are not sufficiently organized or incentivised to challenge boards and hold them to account. Furthermore, shareholders themselves often encourage companies to take excessive risks. It should also be taken into account that there are other parties, apart from owners, who have a legitimate interest in how companies are governed. We further consider that so much of the economy is controlled by entities other than listed companies that it is insufficient either to focus on the corporate governance of quoted companies, or for the UK to continue to define 'public interest entities' in the minimum way that the Statutory Audit Directive permits (that is, listed companies only).

Recommendation 5

A project should be instigated, either by the FRC or BERR, to identify which of the discretionary provisions of the Code, some possibly after amendment, should be made mandatory through the listing rules, or by regulation, or by law – with a broader remit than just for listed companies.

Recommendation 6

There should be a general requirement for companies to obtain shareholder approval for any board decision not to apply a Code principle or not to comply with a Code provision, similar to that which pertains to provisions A.2.2 and B.1.3.

THE INVOLVEMENT IN CORPORATE GOVERNANCE OF EXTERNAL AUDITORS

The third recommendation of the Cadbury Report (1992, p54) was that …

> 'Companies' statements of compliance [with the Cadbury Code] should be reviewed by the auditors before publication. The review should cover only those parts of the compliance statement which relate to provisions of the Code where compliance can be objectively verified. …'

Since 2003, auditors have been expected to review only nine of the now forty-eight provisions of the Code, and none of the forty-three principles. Five of the original Cadbury provisions, which continued to be reviewed after the publication of the 1998 Combined Code, are no longer reviewed. The additional provisions that are now reviewed do not represent 'creep' into other areas – rather, they are a consequence of audit committees being addressed by a larger number of provisions commencing with the 2003 Code; and so the overall result has been a considerable narrowing of auditor attention. Gone is auditor review of provisions on a formal schedule of matters reserved to the board (2003: A.1.1), directors taking independent advice (2003: A.5.2), the selection of non-executive directors (2003: A.7.1) and their terms of appointment (2003: A.7.2), service contracts (Cadbury: 3.1) and non-executive determination of executive remuneration (Cadbury 3.3).

In the light of (a) the development of auditing standards on assurance engagements, (b) the possibility of limiting auditor liability and (c) the Sarbanes-Oxley s404 experience of auditors of US quoted companies, it should be possible for external auditors to assume an expanded role in providing assurance on directors' corporate governance assertions. Many of both the principles and provisions of the Code are wholly or partially verifiable independently. We understand that there is little or no appetite for this on the part of companies, investors or auditors but consider that it could make an effective contribution to enhancing corporate governance.

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Recommendation 7

The FRC should launch an enquiry into the feasibility and desirability of extending the external auditors' role with respect to directors' corporate governance assertions, possibly at the discretion of the reporting companies or their shareholders.

THE CODE'S COVERAGE OF STRATEGY

Many commentators have observed that, while A.1 of the Code (on the responsibilities of the board) gets the balance right between the board's entrepreneurial/strategic and oversight/control roles, most of the rest of the Code focuses on the board's general oversight/control role but with very little focus on strategy or the board's responsibility to oversee strategy.

There has been quite wide concern that the Code's focus on the control side of corporate governance has led to boards becoming excessively preoccupied with this to the detriment of focusing on strategy. It may seem discordant with the mood of the times for ACCA to make this point as there is plenty of evidence that boards have been failing in their oversight/control role. But much of the current malaise is a consequence of companies adopting ill-conceived strategies which have proved to be too risky.

Recommendation 8

The Code should contain more guidance on the board's responsibility for strategy and the means by which strategy should be developed, implemented and overseen.

SPECIFIC ISSUES FOR COMMENT RAISED BY THE FRC

We address in this section the specific consultation issues set out in the FRC paper.

1) 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.

We do not consider that there is any significant force behind the statement in the Code that 'boards are expected to apply the principles', while having flexibility at the level of the provisions. Whatever the expectation and whoever expects it, despite the different wording in Listing Rule 9.8.6 used with respect to 'principles' on the one hand compared to 'provisions' on the other, the FSA has never, to our knowledge, used this rule to discipline a company for failing to apply a Code principle. We understand the FSA regards all of this as merely a disclosure obligation. Furthermore, since the rule does not give 'comply or explain' status to the Code's principles, it is harder to work out from many annual reports whether or not a company is applying many of the Code principles than whether they are complying with the provisions, even though the principles are more fundamental than the provisions.

2) Which parts of the Code have worked well, and which of them need further reinforcement?

The effects of excessive flexibility

The wording of some of the provisions enables a company to claim to be in compliance with them even when it is not following the best practice that the sentiment within each of these provisions is enunciating. It is true that in each of the examples we show immediately below, the provision 'requires' the company to explain their deviation to shareholders but that is a 'requirement' anyway with respect to non-compliance with any provision. Provisions A.2.2 and B.1 additionally 'require' obtaining shareholder support in advance of deviating from best practice, but even when such approval is obtained we consider the provision should be phrased so that this amounts to non-compliance with the provision.

(We have put 'requires' in quotes as no provision in the Code is a requirement, each being discretionary.)

Examples of excessive flexibility within the Code, allowing a company to claim compliance when it deviates from best practice, include the following:

- A company may be fully compliant with provision A.2.2 even if the chairman was not independent when appointed to the chairmanship;

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- A company may be fully compliant with provision A.3.1 when it judges a director to be independent notwithstanding that the director 'fails' to meet some of the stated independence 'criteria';

- A company may be fully compliant with provision B.1.3 even when the remuneration of its non-executive directors includes share options;

- A company may be fully compliant with provision C.3.5 even if it has no internal audit function.

- A company may be fully compliant with provision C.3.6 when the board does not accept the advice of its audit committee on the appointment, reappointment or removal of the external auditors.[1]

Recommendation 9

While retaining the requirements to consult with shareholders in advance, the wording of all the provisions should be such that a company cannot claim compliance with them when they deviate from the best practice stated within the provisions.

Recommendation 10

Compliance with provision C.3.5 should require that a company has an internal audit function. In line with UK public sector practice, the internal audit function should be required to express to the board an overall opinion on the effectiveness of internal governance processes, risk management and internal control. The relevant Code provision should state that the internal audit function is to be regarded as a cost of running the board, and that the head of the internal audit should report administratively (for 'pay and rations') and functionally to the chairman of the board (or, where the chairman was not independent when appointed, to the board, to its audit committee, or to its senior independent director). The board might decide that an internal audit function organised on this basis contributes to the satisfaction of their need for independent assurance (see Recommendation 1 above).

[1] This would not be possible for a company quoted in the US: s301 of the Sarbanes-Oxley Act (2002)

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Outside advice

The Code does not stipulate that audit committees should be empowered to take outside advice although, at A.4.6 and B.2.1 respectively, the Code covers the likely need for the board's nomination and remuneration committees to do so; and A.5.2 applies this to directors individually as well as stating that board committees should be provided with sufficient resources, although not specifically mentioning outside advice.

> **Recommendation 11**
>
> **The Code should unambiguously state that the terms of reference of all board committees referred to within the Code should empower them to take outside advice at the company's expense.**

Materiality of controls and systems

Commencing with the 2003 Code, provision C.2.1 was amended to add 'material' in front of controls, and 'systems' after management. It currently reads as follows (our italics):

> 'The board should, at least annually, conduct a review of the effectiveness of the group's system of internal controls and should report to shareholders that they have done so. The review should cover all ***material*** controls, including financial, operational and compliance controls and risk management ***systems***.'

It is not clear why those 2003 changes were made. Adding the word 'systems' has been counterproductive as it permits a company to claim compliance with this provision when the board (or its audit committee) reviews the risk management *process* but does not review the specific risks that the entity faces and which the process may or may not have identified and mitigated.

Reporting the board's opinion on internal controls

It has never been a 'requirement' of this or any other Code provision that the board should report publicly their opinion of the effectiveness of internal control and risk management. Indeed, the way this provision is phrased means there is no literal obligation for the board or its audit committee to come to any conclusion (even just for use internally) as to whether the company's internal

control and risk management procedures are effective – the requirement is merely to 'review the effectiveness'. Similarly, provision C.3.2 does not require the audit committee to express to the board an overall opinion on risk management and internal control – just to review. We note that s404 of the Sarbanes-Oxley Act requires the company to certify publicly the effectiveness of internal control over financial reporting. We note that some UK listed companies voluntarily publish their opinion on internal financial control effectiveness (e.g. Shell).

Risk committees

Provision C.3.2 refers to the possibility that the board may have a board risk committee separate from its audit committee, but the Code does not set out any provisions that should apply to such a committee except that it should be composed of independent directors (C.3.2) if it is to substitute for the audit committee. We consider that the current economic crisis suggests that it would be preferable for boards to have such risk committees, not least in view of the other burdens placed upon audit committees.

Recommendation 12

The word 'systems' should be removed from the end of provision C.2.1; a specific requirement should be built into C.2.1 for the board itself to consider and approve a high level risk assessment of the company.

Recommendation 13

Provision C.3.2 should be amended to require the audit committee to express to the board its overall opinion on the effectiveness of internal control and risk management.

Recommendation 14

FRC should consider requiring published directors' reports to include an overall opinion of the board on the effectiveness of internal control and risk management.

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Recommendation 15

The Code should include provision(s) relating to risk committees of the board, which should comprise exclusively independent directors. The cost of the company's head of risk management should be regarded as a cost of running the board and should report directly to the board as suggested elsewhere in this submission in the case of internal audit (see Recommendation 10). The board might judge that the risk management function, as with internal audit, meets part of their requirement to receive independent assurance (see Recommendation 1).

Incentives

Perverse incentives, that result in excessive risk taking and undeserved rewards, need to be avoided. Profits that involve high risk to an organization should trigger a smaller bonus than a similar profit which involves less risk. Payments should be avoided or delayed (e.g. held in an escrow account) until profits have been realised, cash received and 'profits' cannot reverse.

Recommendation 16

The Code should be amended to address the unacceptable aspects of executive remuneration that have been an accompaniment of the current economic crisis.

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

We do not consider that this has been the case other than to the following extent:

(i) We have expressed (above) concern that the Code's stress on the oversight of control has downplayed the importance of the board's oversight of strategy.

(ii) We have some concerns that the well-intentioned strengthening of audit committees has tended to insulate boards themselves from first-hand engagement with the issues being addressed by audit committees.

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

Recommendation 17

The following need to be addressed in the Code:

1. **Corporate social responsibility**
2. **Sustainability**
3. **Gender balance**

5) Is the 'comply or explain' mechanism operating effectively and, if not, how might its operation be improved?

We have expressed our view above that investor engagement cannot be adequate to ensure high standards of corporate governance, and so the 'comply or explain' approach cannot be relied upon to be effective and has been shown to have failed. Much that is currently discretionary needs to be made mandatory.

6) The FRC additionally invites 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;

Clearly, many boards have proved to be ineffective. We have suggested (above) measures to improve the effectiveness of non-executive directors and the degree of independent assurance that boards receive. We consider the Code's concept of a balanced board to be sound, but note that companies often compromise on the avoidance of excessive power at the top of the business and on the independence of the chairman. We have suggested the Code should unambiguously support the need for all board committees to be empowered to take outside advice. We have suggested that provision should be made, as an option, for two-tier boards for UK listed companies.

7) The board's role in relation to risk management

We have suggested rewording provision C.2.1, building risk committees of independent directors into the Code provisions relating to boards, and requiring the formulation of overall opinions on the effectiveness of risk management and internal control.

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8) The role of the remuneration committee;

We have addressed this in the context of rewording the provisions on the remuneration committee so as to address the issue of perverse incentives.

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

We have indicated our concern about the control by the executive of the information flow to the board, and have recommended that boards should be required to obtain assurance independent of the executive.

10) 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.

While, as we have said above, we should not expect to rely upon shareholders alone to achieve high standards of corporate governance in the companies they own, the active monitoring of board behaviour, and the responsible exercise of shareholder rights, are integral elements of the governance process. As has been evidenced by the banking crisis, there is much potential for improvements to be made in this area. We believe that boards should be encouraged to act pro-actively in their engagement with shareholders, in particular with institutional investors, with a view to understanding and, where appropriate, accommodating their legitimate concerns about the company's direction. As well as helping to maintain constructive effective working relationships with investors, this process should be seen by boards as assisting them to comply with their legal responsibilities under section 172 of the Companies Act 2006.

11) Concerns over the continuing effectiveness of the 'comply or explain' approach

In our opinion, the concerns have increased as there have been more examples of how this approach has proved to be inadequate. As explained above, we do not consider that tinkering with the 'comply or explain' approach will address the problems with it.

We would be happy to discuss any of the contents of this submission with you further.

Yours sincerely

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Chairman
ACCA Corporate Governance Committee

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