

20 March 2008

Our ref: ICAEW Rep 31/08

Lalitha Colaco-Henry
Primary Markets Policy Department
Financial Services Authority
25 The North Colonnade
Canary Wharf
London E14 5HS

Dear Ms Colaco-Henry

Consultation Paper 07/24: Implementation of the 8th Company Law Directive

The Institute of Chartered Accountants in England and Wales welcomes the opportunity to comment on the Financial Services Authority's (FSA) consultation paper 07/24: *Implementation of the 8th Company Law Directive*.

With the exception of the proposal to delete LR 9.8.6R(5), the application of the principles of the Combined Code, we generally support the main proposals in the consultation paper. We do however have a number of comments which we hope will help the FSA in implementing the relevant aspects of the 4th and 8th Directives.

In developing European-level policy, the European Commission has based much of the content of these two Directives on the Combined Code on Corporate Governance. Given that UK policy is generally code and guidance-based and not law or rules-based, we fully support the government's intention to provide maximum flexibility and adopt a 'light touch' approach to the implementation of the two Directives.

In our view, it is important that companies and investors:

- see that the FSA's implementation of the Directives is as close as possible to the equivalent requirements in the Combined Code; and
- see the FSA's rules as minimum requirements and continue to strive to achieve the additional good practice set out in the Code. Nothing should be done to diminish the high standard of corporate governance that has been achieved by UK companies through the Combined Code.

Please contact Jonathan Hunt (Head of Corporate Governance) or myself should you wish to discuss any of the points raised in this response.

Yours sincerely

A handwritten signature in dark ink, reading "Robert Hodgkinson". The signature is written in a cursive style with a large initial 'R'.

Robert Hodgkinson

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ICAEW Representation

ICAEW REP 31/08

CONSULTATION PAPER 07/24: IMPLEMENTATION OF THE 8TH COMPANY LAW DIRECTIVE

Memorandum of comment submitted in March 2008 by The Institute of Chartered Accountants in England and Wales, in response to the Financial Services Authority's consultation paper 07/24: *Implementation of the 8TH Company Law Directive*.

INTRODUCTION

The Institute of Chartered Accountants in England and Wales (ICAEW) welcomes the opportunity to comment on the Financial Services Authority (FSA) consultation paper on proposed implementation of the audit committee aspects of the 8th Company Law Directive (the Statutory Audit Directive) and the corporate governance aspects of the 4th Company Law Directive (the Company Reporting Directive).

WHO WE ARE

The ICAEW operates under a Royal Charter, working in the public interest. Its regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the Financial Reporting Council (FRC).

As a world leading professional accountancy body, the ICAEW provides leadership and practical support to over 130,000 members in more than 140 countries, working with governments, regulators and industry in order to ensure the highest standards are maintained.

The ICAEW is a founding member of the Global Accounting Alliance with over 700,000 members worldwide.

Our members provide financial knowledge and guidance based on the highest technical and ethical standards. They are trained to challenge people and organisations to think and act differently, to provide clarity and rigour, and so help create and sustain prosperity. The ICAEW ensures these skills are constantly developed, recognised and valued.

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DETAILED COMMENTS

A. Statutory Audit Directive

Q1. Do you agree with, or have any comments on, our proposed approach to the implementation of the Statutory Audit Directive?

Proposed FSA rules and interaction with the Combined Code

The ICAEW supports implementation of the Directives by FSA rules rather than by the creation of new legislation in the Companies Act.

We believe that compliance with the provisions of the Combined Code and related disclosure requirements in respect of audit committee composition and function should be enough to ensure compliance with the FSA's rules. The good practice provisions in the Combined Code and the Smith guidance on audit committees are more extensive than the minimum requirements of the Directive.

We consider that many UK companies listed on the Primary Market of the London Stock Exchange are already compliant with the relevant requirements of Article 41 as they comply with the Combined Code's recommendations regarding audit committee function and composition.

As noted in the covering letter, in developing European-level policy the European Commission has based much of the content of the two Directives on the Combined Code. Given that UK policy is generally code and guidance-based and not law or rules-based, we fully support the government's intention to provide maximum flexibility and adopt a 'light touch' approach to implementation.

In our view, it is important that companies and investors:

- see that the FSA's implementation of the Directives is as close as possible to the equivalent requirements in the Combined Code; and
- see the FSA's rules as minimum requirements and continue to strive to achieve the additional good practice set out in the Code. Nothing should be done to diminish the high standard of corporate governance that has been achieved by UK companies through the Combined Code.

Recent and relevant financial experience vs. competence in accounting and/or auditing

Paragraph 2.5 of the consultation paper uses the phrase 'financial expertise' in place of 'competence in accounting and/or auditing', the wording used in the Directive.

We agree that the FSA should not prescribe what would constitute 'financial expertise' or 'competence in accounting and/or auditing' as these matters should be considered in the individual circumstances of a company particularly in relation to the nature and complexity of the business.

However, were the FSA rule in the DTR to reflect the words in the Directive, then we believe that it would be helpful for the FSA to give a steer on a pragmatic interpretation of that wording.

We consider that 'competence in accounting and/or auditing' is different to, and probably a sub-set of, the more pragmatic wording in provision C.3.1 of the Combined Code. The

provision states that ‘The board should satisfy itself that at least one member of the audit committee has recent and relevant financial experience.’

‘Competence in accounting and/or auditing’ does not mean that the individual to whom this is attributed would be a good non-executive director. In extremis, someone who is competent in the technical aspects of financial reporting or someone who is a good internal auditor (whose work might have nothing to do with financial reporting) would satisfy the requirements of the Directive.

Whilst such individuals might make good advisors to an audit committee they would not automatically be suitable board directors. Given that, under the Combined Code, all members of an audit committee are non-executive directors on a board, then under the UK’s unitary board system it is important that boards contain individuals who are capable of acting as a director of a publicly listed company. Such individuals will require knowledge and expertise which extends beyond competence in accounting and/or auditing.

Our strong preference is for the ‘recent and relevant financial experience’ wording used in the Code which highlights the importance of ‘recent experience’ implying up-to-date practical knowledge. It is also important to refer to ‘relevant’ to reflect the individual needs of companies of different sizes and varying degrees of complexity.

We therefore urge the FSA to consider making a statement that a company which has complied with the ‘recent and relevant experience’ criterion of Code provision C.3.1 will satisfy the requirement of the DTR.

Independence, financial expertise and ‘a body performing equivalent functions’

Paragraph 2.5 states that “....such body have at least one independent member and a member who has competence in accounting and/or auditing. The independence requirement and the financial expertise requirement may be fulfilled by one and the same person, but need not be.”

Care should be taken in a company where there is no audit committee and the board takes on the role of ‘the body performing equivalent functions’. In these specific circumstances it is possible that, with two people fulfilling the requirements of the Directive, paragraph 2.5 could lead to unintended problems.

For example, the requirements of the Directive could be achieved by (a) the finance director having the financial expertise and (b) an independent director who has little or no financial expertise. The finance director is part of the management of the company and, as such, is not classified as a non-executive director.

Such a situation would not satisfy the *raison d’être* for an audit committee and the FSA should give consideration to this, and other possible examples of how companies might achieve form over substance, before the FSA finalises its rules.

Monitoring and Enforcement

We welcome the collaboration between the FSA and the Financial Reporting Review Panel in the monitoring and enforcement of aspects of the 4th and 8th Directives.

B. Company Reporting Directive

Q2. Do you agree that LR 9.8.6R(5) should be deleted?

No we do not agree. Deletion of LR 9.8.6R(5) would, in our opinion, be a backwards step for UK corporate governance. We believe that the current requirement relating to the application of principles must be retained.

Corporate governance in the UK adopts a principles-based approach supplemented by 'comply or explain'. This is often contrasted favourably with some other jurisdictions whose approach is based on strict compliance with rules.

We believe that:

- the Code's main and supporting principles go to the core of a board's behaviour and its attitude to the application of corporate governance;
- the requirement to make these disclosures can make boards think carefully about their governance responsibilities at least as part of the process to 'sign off' their annual report to investors;
- investors value the narrative information that is already provided by boards on how companies have applied the Code's principles;
- whilst some clarification and improvement may be needed on how companies should apply Code principles, this is not an excuse for deletion from the Listing Rules; and
- as companies should already be providing disclosures under the existing rules, there should be little additional work needed in keeping these, not very onerous, disclosures up to date.

Consequences of the deletion of LR 9.8.6R(5) could include:

- decreased emphasis on application of the principles of corporate governance;
- loss of information that is beneficial to investors. In spite of accusations of boilerplate disclosure, we believe that investors find this information useful as it provides some insight into how a board has thought about corporate governance. Such information would be less apparent if corporate governance disclosures were limited to requirements in respect of the Code provisions alone;
- an over-emphasis on the more compliance orientated parts of the Code. This could result in increased compliance-only box-ticking; and
- sending an unfortunate political message that the UK was relaxing its commitment to principles-based corporate governance.

What may now be necessary is for the FSA and/or the FRC to express a view on how LR 9.8.6R(5) is interpreted. We would be happy to contribute to the development of such a view.

Q3. Do you agree that the exemption should apply to issuers of preference shares and issuers of securities convertible into shares that do not have such securities admitted to trading on a multilateral trading facility?

Yes we agree.

Q4. Do you agree with, or have any comments on, our proposed approach to the implementation of the Company Reporting Directive?

We make the following comments.

Scope

We note that the Directive applies to 'all companies whose securities are admitted to trading on a regulated market'. This is a more extensive requirement than that under LR 9.8.6R(6) which applies to issuers with a primary listing of their equity securities on the London Stock Exchange.

We hope that the FSA will ensure that all such companies are made aware of the new requirements when the final rules are published as it is quite possible that such changes may have fallen under the radar of some, particularly smaller, companies.

Location of the corporate governance statement

We support the proposal to allow companies to choose whether to publish the corporate governance statement in the directors' report or separately.

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