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ICAEW Rep 20/05

Mr Chris Hodge  
Corporate Governance Unit  
Financial Reporting Council  
Fifth Floor  
Aldwych House  
71-91 Aldwych  
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Dear Mr Hodge

### **FRC Review of the Implementation of the 2003 Combined Code**

I have pleasure in submitting the response of the Institute of Chartered Accountants in England & Wales (ICAEW). Our detailed comments are provided in the appendix.

The ICAEW operates under a Royal Charter, working in the public interest, and is the largest professional accountancy body in Europe with over 127,000 members in business, practice, the public and voluntary sectors and academe. In preparing this response we have taken account of the views of a number of ICAEW members and individuals who have substantial experience as listed company directors, institutional investors and auditors.

If you wish to discuss our suggestions in further detail, please do not hesitate to contact Jonathan Hunt or myself.

Yours sincerely



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## Summary

We see little need for changes to the Code at this time with two possible exceptions. Firstly, and the more significant matter, is the issue of the financial expert on the audit committee which we discuss in section 2A below. Formalising the membership of the board chairman on the remuneration committee may also be of practical use and a second possible change to the Code. Other matters could more easily be dealt with in the Preamble to the Code, or by other means of communication, without changing the Code. We comment at the end of this appendix on the two potential additions highlighted by the FRC.

## Support for the FRC's approach and the need for consensus

We applaud the approach adopted by the FRC in performing its review of the Code. In particular, we support the decision to gather evidence prior to considering whether any potential changes are necessary and then subjecting these proposed changes to further public consultation in 2006.

We strongly support the FRC's comment that amendments or clarifications to the Code will only be considered if there is a strong consensus that they are needed. We fully subscribe to the need to avoid making change for change's sake and we highly commend the FRC for developing and applying the 'four tests' which featured in the work of the Turnbull Review Group. It is essential that any proposed revisions to the Code be capable of attracting widespread support from business and investors.

## Implementation issues

### General comment

The 2003 Code was reported against for the first time in 2005 and our views are based on experience to date. For some aspects of the new code, it may be too soon to determine fully how effective the changes in the 2003 Code have been.

### **(1) Has the Code begun to have an impact on the overall quality of corporate governance in UK listed companies? Are there any areas in which practice has notably improved?**

Yes. The Combined Code has had a positive effect on the way in which companies are governed.

Within the constraints noted in the general comment above, we suggest that areas where practice had improved include:

- board evaluation; and
- NED induction training.

Looking wider than the revisions made to the 2003 Code, we also believe that risk management and internal control have improved over the past few years.

## **(2) Have companies come up against any practical barriers to implementing the Code?**

We highlight three main issues:

- one member of the audit committee should have recent and relevant financial experience;
- a gradual reduction in the number of executives serving on boards; and
- the board chairman's membership of the remuneration committee.

- A. Code provision C.3.1 - one member of the audit committee should have recent and relevant financial experience.

Section 407 of the US Sarbanes Oxley Act, enacted in July 2002, requires SEC registrant companies to disclose whether or not (and if not, why) the audit committee of an issuer includes at least one member who is a 'financial expert'. The subsequent SEC rules defined 'financial expert'.

The singling out of, at least, one individual on the audit committee as having financial experience/expertise has been followed in the 2003 Combined Code and the Smith guidance on audit committees as well as in Article 39 of the forthcoming revised EU Eighth Company Law Directive. The latter states that "at least one member of the audit committee shall be independent and shall have competence in accounting and/or auditing."

The ICAEW has had a longstanding position that the audit committee as a whole should have, and have access to, recent and relevant experience to enable the committee to discharge its responsibilities rather than identify one individual as being so qualified (with the potential implication that the other members are not qualified).

We believe that with an ever increasing volume of standards, regulation and law, it is now unrealistic to expect one individual to have all the relevant knowledge to properly discharge this increasingly onerous duty. For example in highly complex groups (e.g. financial services) this is now potentially a very significant undertaking for one individual. In addition, even with updating and training courses, ensuring knowledge remains 'recent' is an issue, as many such designated experts may well be retired finance directors or audit partners. Finally, there is a concern that such a position exposes the specific individual to additional risk of liability and reputational damage.

The FRC may wish to consult further on this matter, including with the DTI on how they will implement Article 39.

We recognise that the individual responsibility approach may be more suitable for other jurisdictions, but that is a matter for them. We strongly prefer collective responsibility rather than individual responsibility in relation to the audit committee, believing that this is more appropriate to the UK's general approach to corporate governance and the unitary board concept.

- B. We suggest that a consequence of Code provision A.3.2 (at least half the board, excluding the chairman, should be independent non-executive directors) has been a gradual reduction in the number of executives serving on boards. A potential

consequence of this change is the loss of experienced and capable executives in the boardroom that, in extremis, could impact on informed decision taking by boards.

Whilst we do not, at this time, suggest a change to the Code, we strongly suggest that the FRC should emphasise the importance of having a balanced board to help ensure informed decision taking.

- C. Code provision B.2.1 states the board's remuneration committee should comprise at least three independent non-executive directors.

We strongly support the view that the chairman of the board, whose role includes oversight of the balance of the board, should be allowed to be a member of the remuneration committee. We believe that this would formalise what has already happened in practice with chairmen being routinely invited to attend meetings.

**(3) What impact has the Code had on smaller listed companies, in particular those outside the FTSE350?**

As an overall comment, regardless of the size of the company, we believe that the Code has encouraged a degree of formality and structure in governance practice.

Whilst some smaller companies had found this year quite challenging as they get up to speed in implementing the revised Code, they will continue to improve in future years.

Smaller companies may be finding it difficult to implement the Code's recommendations due, in some cases, to resource constraints. For example, the potential cost incurred for board evaluations if an external consultant is employed.

**(4) How informative are the corporate governance statements in the annual reports, and has there been a change in the overall quality of the disclosure?**

We believe that the quality and quantity of information provided by the board to shareholders has substantially improved in recent years.

In line with the UK's evolutionary and considered approach to the development of corporate governance there may be opportunities for boards of companies to continue to improve their disclosures. An example might be on how they have applied the Code principles. This is a matter the FRC may wish to emphasise in, say, a preface to any revisions to the Code.

**(5) Where companies are choosing to explain rather than comply with a particular provision, how informative are those explanations and are they being accepted by shareholders?**

We believe that:

- explanations have been generally adequate;
- there is increasing recognition that non-compliance with the Code may well be acceptable in the particular circumstances of a company; and
- institutional investors are becoming more competent in their role of critically assessing explanations of non-compliance.

**(6) Has the Code had an impact on the level and quality of dialogue between boards and their shareholders?**

Yes. We believe that communication between directors and investors in mutually pursuing the best interests of the company has improved as a result of the Code. However, there could be better co-ordination and relationship management between shareholders and directors.

We suggest that the ongoing relationships between shareholders and the Senior Independent Director (SID) do not appear to be developing. We believe that, although it is important that this point of contact exists, in practice investors are more likely to be only interested in talking to SIDs when there is a problem.

## **The two potential additions to the Code**

### **A Potential amendment: Votes withheld**

Whilst recognising that, for investors, registering a 'vote withheld' is an expression of dissatisfaction and a step below voting 'against' a proposal and may increase investor engagement, overall we believe that investors should be encouraged to come to a clear decision when casting their votes. Formally withholding a vote / abstaining should be used only rarely.

If the FRC does proceed with this potential addition, it may care to consider any potential consequences of this change, such as the impact it might have on the practicalities of passing resolutions. For example, do votes that are cast as 'withheld' count as part of the total votes cast? If the answer is yes, what might then be the consequences and practical difficulties for companies in achieving the 75% threshold to pass a special or extraordinary resolution?

### **B Potential amendment: Audit engagement letters**

If there is an overall consensus that publishing the contractual terms between audit firms and company directors which comprise an audit engagement letter will provide value to investors, then we would prefer to see the matter achieved through the Code rather than statute.

An alternative, as with directors' service contracts, would be to have the audit engagement letter made available on request.