Beware the Gospel according to London!

The New UK Corporate Governance Code (Part I)

"Could do better," would be my report card comment on the Financial Reporting Council after reading the new UK Corporate Governance Code published in June this year. So much of the new UK Code is a rehash of the 2006 Combined Code. New headings and easy flow offer clarity, but it is largely a change of tone. I expected better of the FRC.

Why should we worry about this in Malaysia? Recently announced efforts to upgrade our existing corporate governance framework might tempt some to drop chunks of the new UK Code, unedited, into our Malaysian Code. Benchmarking against international best practice will be the cry. Before that happens, a word of caution: ***Beware the Gospel according to London.***

The FRC had an opportunity to tackle some important corporate governance issues exposed by the financial meltdown, but London appears tied to the old doctrine. Today, comply or explain is the minimum standard; best practice has become ***apply and explain***! That's not a plea for the adoption of prescriptions; it's a call for the application of principles.

To be fair, there are things in the new UK Code worthy of commendation, but there is also incomplete thinking which could produce unwelcome consequences. Let's take a closer look at some of the key changes and some of the retentions.

The focus remains on the Board and its role in facilitating *"effective, entrepreneurial and prudent management"*. Reflecting recent changes to the UK Companies Act, the emphasis is: *"accountability, transparency, probity and ……the sustainable success of an entity over the longer term."*

The important roles of the Chairman and the CEO are covered in the Preface to the UK Code which suggests a relationship that encourages an open minded, honest address of corporate issues. This is far more explicit than before.

The Chairman is now specifically tasked with reporting *"personally"* in the annual statement on how the Board has applied the principles relating to its role and effectiveness. The new UK Code bravely attacks the *"fungus of the boiler-plate"* as *"dead communication"*. What a challenge for Malaysian companies which prefer the safe haven of the template. How many corporate governance statements read the same year after year? How many companies publish terms of reference for Board Committees as if they give a picture of what really takes place?

Job descriptions for the Board and its Committees may be the next step, replacing terms of reference. Even better, perhaps we can get Boards to report on what they achieved, not the way they organised themselves. That's not unimportant, but what really matters is the issues the Board addressed, how those issues were resolved and how the Board believes it added value to the enterprise. Reports from Board Committees are meaningful if they talk about their work, not the number of meetings held. Let's get the focus where it should be – on the deliverables that should be expected from the Board. Terms of reference should be expelled from the main body of the Annual Report; make them available on request, as a supplement, or have them on the company website. If this is a death blow for the 500 page Annual Report and the prolix catalogue of compliance we are better for it. A discourse on effectiveness will be far more illuminating. ***Apply and explain*** offers much less hiding space for the Board interested in the easy option.

The Minority Shareholder Watchdog Group will be delighted to have genuinely informative annual reports. They will also appreciate the new reporting requirement that an explanation is provided of the corporate business model (how the company generates and preserves value over the longer term) and the strategy for delivering the corporate objectives. This useful addition would be even better, however, if the UK Code required a description of the strategy development process, along with a discussion of progress towards meeting the strategic objectives, the immediate goals and the risks being faced. This is disappointingly absent.

Risk management is another area which begins with promise, but fails to deliver. The new UK Code breaks ground by making it a Board responsibility for *"determining the nature and extent of the significant risks it is willing to take in achieving its strategic objectives"*. However the follow through is weak. The mention of risk management is simply woven, like an after thought, into the existing provisions about internal controls.

Attention to risk, the ways it manifests itself, the means for its measurement and analysis of its potential impact on the future of the company is a major Board responsibility. One only needs to look at some recent corporate collapses to find compelling examples of the lack of appreciation of risk and its oversight at Board level. Yet the UK Code satisfies itself with the almost meaningless statement: *"The board should, at least annually, conduct a review of the effectiveness of the company's risk management and internal control systems and should report to shareholders that they have done so."* That's an invitation for a compliance report and little else.

Internal Audit deserves closer attention. Directors are expected to give assurances to shareholders about the robustness of internal controls and cannot rely on what external auditors say as a basis for making the positive statements that are required. There is nothing in the new UK Code which addresses this new reality.

There is nothing either of the need to report to shareholders on risk appetite or the processes for identifying and measuring risk. There is no requirement to describe the risks which could interfere with meeting corporate objectives or the Board's assessment of the potential impact on corporate strategy. There is no suggestion that Risk Management, like Internal Audit, should be an independent management function which reports directly to the Board. An opportunity to upgrade expectations of Directors when it comes to internal controls and risk management has been missed and the new UK Code is weakened as a result.

Executive remuneration gets an airing, but it seems a knee jerk response to current public opinion. Much more damage can be done to a corporate entity by bad risk management and poor controls than the perversities of its executive pay structure. Pay is also more easily fixed. However, there's PR mileage in talking about pay, and I'm disappointed the new UK Code falls into this trap instead of concentrating on governance realities.

Yes, a healthy portion of executive pay should be linked to corporate and individual performance. Yes, rewards should be designed to promote long term success and, yes, there should be some provision for claw-backs if actual results do not live up to promise. The old phrases about pensions being related to base pay ring loud now against the background of the significant pensions granted to some departing executives who wrought great havoc on their organisations.

I have no quarrel with any of that, but I am concerned the new UK Code fudges some important issues and sets a tone of unrealistic idealism in other areas. We'll explore this tomorrow in Part II.