



Review of the impact of the Combined Code

A response from the Local Authority Pension Fund Forum

LAPFF Secretariat, Stuart Imeson,
Bradford City Council, Britannia House, Hall Ings, Bradford, West Yorkshire
BD1 1HX
Tel +44 (0)1274 43 23 17 , Fax +44 (0)1274 43 77 00
Email: Stuart.Imeson@bradford.gov.uk

Introduction

The Local Authority Pension Fund Forum, which was set up in 1991, is a voluntary association of 42 public sector pension funds based in the UK. LAPFF exists 'to promote the investment interests of local authority pension funds, and to maximise their influence as shareholders to promote corporate social responsibility and high standards of corporate governance amongst the companies in which they invest.' The Forum's members currently have combined assets of over £80 billion. For further information please see our web site at www.lapfforum.org

Does the Code support better board performance over time?

LAPFF considers that the framework provided by the Combined Code provides a good base standard against which shareholders can monitor governance standards within companies. With Code compliance being a UK listing requirement there is little doubt that the Code has contributed to boards becoming more accountable and effective.

Research has shown that there has been increasing compliance over time in the areas of board independence, separation of roles at the head of the company and committee membership, especially amongst larger companies.¹ There is little doubt that the introduction of the Code and subsequent monitoring by investors and associated voting at AGMs has led to an overall improvement in standards of governance which support better board performance. We further believe that poor governance procedures, philosophies and approaches are associated with adverse business outcomes.

The Forum extends its involvement with companies from monitoring and voting to direct engagement when it considers particular circumstances demand this, or if it has a pre-identified programme of engagement. A case in point is the particular circumstances of the Morrison takeover of Safeway. The Forum had, in common with many other investors, concerns at the lack of any non-executives on the board and the controlling position held by Sir Ken Morrison as executive chairman. This concentration of power in the hands of one individual contributed to policy decisions which were not the optimal ones for determining future business strategy.

The Forum's work on mergers and acquisitions has included assessing this merger, leading to the identification of a number of areas that investors at the time could have recognised as weaknesses of the acquisition, had they adopted a long-term perspective and taken into account non-financial aspects of the deal. The Forum's conclusion is that this was a takeover with a high level of avoidable implementation risk, in combination with some degree of uncertainty in the acquirer's synergy assessment. The elevated risk level was not adequately compensated for in the valuation of the target. Concerns over

¹ Corporate Governance Annual Review 2006, PIRC Limited, London 2006

corporate governance at Morrisons are significant in this context, as they reduced the likelihood of successful engagement with the company pre-deal. It is crucial, where influence is concentrated in only one or two individuals, that there are robust and transparent governance structures. Compliance with the Code in this instance would have provided balance in the board make-up and would have facilitated company strategy to be questioned in an effective manner.

In the absence of effective boardroom governance, shareholders need to continue monitoring companies and in this respect the Code provides an established benchmark of best practice, which has achieved market-wide investor confidence. Indeed, they must do this in the absence of a formal basis upon which companies' compliance with the Code can be assessed, and to what degree their explanations for non-compliance can be considered adequate.

What impact has the Code had on smaller companies?

The Forum considers that the level of market capitalisation should not affect the need for good governance procedures and structures, and that listed UK companies should be encouraged to work towards best practice regardless of size.

As the Code currently stands, differences for smaller companies are already in place. Smaller companies need only have two independent non-executive directors, as opposed to half the board excluding the chairman, required for larger companies.

The Forum provides its members with voting advice based on a number of governance issues, which covers the FTSE 350, and thus does not monitor the impact specifically on smaller companies. The problem for investors in monitoring large numbers of companies is recognised, but in view of the 'comply or explain' regime, we see no reason for smaller companies to have a reduction in reporting requirements.

Do disclosures on the Combined Code in annual reports provide useful information to shareholders at proportionate cost to companies?

Disclosures on Code compliance in annual reports provide some useful information but frequently do not directly address the reason for non-compliance satisfactorily. The Forum considers that a principle of the Code could emphasis of the need for relevant and focused disclosure on circumstances specific to the company.

The Forum currently has a focus on audit procedures at companies and the need for reform in a number of areas². A properly functioning audit committee

² Audit, An Agenda for Reform, LAPFF, January 2007

plays an important role in improving the quality of financial reporting by reviewing the financial statements and creating a climate of discipline and control in the company. An increasing number of companies – although still a minority – are reporting effectively to shareholders on the activities of the audit committee during the year. The Code already requires that companies report on committee activities during the year, but our research found that 23% of companies in the FTSE 350 do not adequately report on the activities of their audit committees; in these cases, the disclosure amounts to little more than a summary of the audit committee's terms of reference. The Forum considers that the Code should reinforce the need for an informative description of the work covered during the year, rather than a general statement of responsibilities.

In conclusion, the Forum believes that the Combined Code has encouraged stronger disclosure in many areas, which has been extremely beneficial to investors. An area that would merit further attention is the need to emphasise the value of good narrative reporting in terms of processes and activities undertaken during the year. This would align well with the approach being engendered by the Companies Act 2006 and the Business Review.