EVALUATING THE IMPACT OF POTENTIAL CODE CHANGES

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Part 1: Process for making changes to the UK Code

Stage 1

Identify issues – new issues, implementation of existing Code:
• Review existing research
• Meetings with company chairmen, senior investors etc

Stage 2

Debate and research issues identified in Stage 1:
• Public consultation
• More meetings (especially with stakeholders unlikely to respond to written consultations)
• Commission new research if needed

Stage 3

• Public consultation on proposed Code changes
• Cost/benefit analysis
• After formal consultation, informally test out drafting changes to ensure they will be interpreted as intended.

Stage 4

• Publish revised Code
• Action to support implementation where needed
Part 2: Case Study: External Board Evaluation

Proposal

Since 2003, the UK Code has recommended that boards should evaluate their effectiveness every year. Some boards have chosen to use external advisers to assist with this process, and this is considered to be good practice. The FRC proposed that all listed companies should carry out an externally facilitated evaluation at least every three years.

Background

In total there are 1400 listed companies on the Main Market of the London Stock Exchange, although many of them are really investment vehicles to whom this recommendation is not particularly relevant. There are about 800 “real” companies.

For indexing purposes, companies are divided into the FTSE 100 (the hundred largest companies), FTSE 250 (numbers 101 to 350), and Small Cap companies. Some provisions in the UK Code distinguish between companies according to their size.

Issues

• What is the cost of board evaluation?
• Are there enough suppliers to meet the demand?
• Are there enough good quality suppliers?

There are other issues as well, such as the potential for conflicts of interest if the advisers provide other services and what should be reported publicly on the results of evaluations.

Costs

Costs vary significantly depending on the process followed.

At one end there is a simple questionnaire process, where directors’ views are collated and passed to the chairman and company secretary to follow up (no more than €10-15,000. A full bespoke review of the board, committees and individual directors which might involve interviews with board members, advisers and stakeholders with detailed analysis and recommendations could rise to as much as €180,000.
Conclusion: while there is obviously a trade off between the costs and the rigour of the process used (and therefore perhaps with the benefit obtained by the board), cost alone would not be a reason to drop the proposal. Companies can choose the process according to their means. And, of course, it is a ‘comply or explain’ recommendation.

Suppliers

We were unable to obtain reliable data on the number of advisers providing board evaluation services - they come from many different disciplines (e.g. recruitment consultants, providers of company secretarial services, auditors as well as specialists) – or how many board evaluations each year they had the capacity to carry out.

So we started at the other end by trying to calculate the current size of the market. If we assumed it was operating at close to full capacity, how much increased demand could the suppliers cope with?

Data suggests that between 15% and 20% of the largest 200 companies will use an external adviser each year (not always the same companies) – 30 to 40 companies. We have no data about usage among smaller companies, but anecdotally we know it is a lot lower. If we assume only 5% of the 600 smaller companies use these services, it takes the total number of companies each year to 60 to 70.

Originally the FRC proposed that this recommendation should apply to all listed companies. We assumed: 100% compliance; that no company would carry out an external evaluation more than once every three years; and that there would be an even spread of companies in each year of the three year cycle. This would result in 260 to 270 evaluations being undertaken every year.

Conclusion: We considered it unlikely that supply would be able to cope with such an increase in demand. We decided to limit the recommendation to the FTSE 350 (the 100 and 250 combined) in the first instance. This would result in a theoretical demand for 140 to 150 evaluations a year (one third of the FTSE 350 plus the assumed 5% of Small Cap companies) – still a significant increase.

Since announcing our decision the FRC has had a number of discussions with potential new entrants to the market, some of whom have now started to provide board evaluation services. We are quietly optimistic that the problem of the volume of supply will solve itself over time. There remains, however, an issue about whether companies are able to identify suppliers – this does not seem to be a problem for the largest companies, who rely on existing networks to exchange information, but may be for smaller companies.
Quality and Accessibility

Anecdotally we have heard concerns about the variable quality of suppliers (this is not solely related to cost and the process used, although that is a factor in some cases). So in considering how to help companies implement the recommendation effectively we considered: how can the quality of supply be improved? And how can companies distinguish between good and bad suppliers?

Various suggestions have been put to the FRC:

- A methodology for carrying out evaluations should be prescribed, which all suppliers would follow;
- The FRC should maintain a list of “approved suppliers”;
- Some sort of trade association for suppliers should be established;
- An independent organisation should publish a directory of suppliers without any attempt to distinguish on the grounds of quality.
- Leave it to the market to “weed out” poor suppliers over time.

Prescribed methodology: there were some supporters, although most had a degree of self-interest. But we rejected the idea because (i) the sort of evaluation companies will benefit from will vary depending on their needs, (ii) it is still an immature market and we are not sure best practice can be identified yet, and (iii) there could be cost considerations for companies.

In addition, there may be some value in guidance to companies that says “these are the sort of issues you ought to consider as part of your evaluation”, which could also be used as a checklist by suppliers. This might help define the scope of the matters they should address, without prescribing how to address them.

FRC approved suppliers: We rejected the idea for the same reasons as set out above, and because if the FRC were to maintain such a list we would need to establish assessment criteria and monitoring systems. We do not have the resource or expertise to do that at the moment, even if it were felt desirable.

Membership association: We consider there is some merit to this idea but the terms of which it was established would need to be clear so that it did not operate in effect as a cartel i.e. there would need to be transparent membership criteria that enable any supplier who met them to join, and there would need to be some independent oversight and monitoring of that process and whether members abided by whatever standards they signed up to.

Directory of suppliers: This would solve the problem of how companies can identify suppliers, without addressing the quality issue.