

Corporate Governance

Presentation to Joint Committee on Economic Regulatory Affairs

12 May 2010, 2.30PM

Mr Chairman, Deputies, Senators

Thank you for inviting us to appear before the Oireachtas Joint Committee on Economic Regulatory Affairs.

Grant Thornton Corporate Governance Review

The most recent Grant Thornton Corporate Governance Review was published in March of this year. This is the fourth year that we have published the review, which assesses the level of compliance of companies on the Irish Stock Exchange's Main Securities Market with their compliance framework, the Combined Code on Corporate Governance.

The methodology of the report has not changed significantly in those four years. In the first two years of publication, the report received little attention outside of those with a pre-existing interest in the topic. However, in 2009, the third year of publication, the report received significant media attention and public attention, and was mentioned in the Dáil and quoted in numerous articles in the national press. Some of the responses were unfavourable, suggesting that we were being too critical of governance standards. Our report contained a number of recommendations, including the suggestion that the key provisions of the existing governance framework should be incorporated into legislation, a suggestion that was subsequently incorporated into the Renewed Programme for Government.

In 2010, the latest edition of the report echoed and expanded upon our recommendations for 2009, and I will explain these recommendations in more detail shortly. A number of our key points from the most recent reviews have been echoed by the Financial Regulator in statements and in Consultation Paper CP41 on Corporate Governance Requirements for Credit Institutions and Insurance Undertakings. These points include those in relation to the balance and independence of boards, the role of the chairman and the clear separation between chair and chief executive, limits on the number of directorships which directors can hold in listed or regulated entities, more active involvement by boards in the risk management process, and the need to balance principles-based and rules-based regulation.

Scope and methodology of the review

The report itself covers companies listed on the Main Securities Market of the Irish Stock Exchange (ISE), at the time of their most recent annual report. This includes not only many of the largest companies in the State, but several companies with significant state shareholdings, including Aer

Lingus, AIB, Bank of Ireland and Anglo Irish Bank, which was still listed on the ISE as of the most recent annual report available when our report was being prepared in late 2009 and early 2010.

The regulatory framework for these companies is, aside from the Companies Acts which apply to all companies, the Combined Code on Corporate Governance issued by the Financial Reporting Council in the UK. Listed companies are required, under the ISE's Listing Rules, to make a statement as to whether they comply with the Combined Code, and if not, to explain which provisions they do not comply with. Sanctions for non-compliance with the Code extend to censure of companies or directors, and suspension or delisting of shares.

Corporate governance is not just a theoretical framework for how companies should ideally be run. It is a series of practical mechanisms, operating at board and management level, that aim to ensure that the shareholders, stakeholders and others with a vested interest in the performance of a company, gain assurance that their interests are protected. For companies on the ISE, these stakeholders include taxpayers, the State, the Government, those with pension funds, institutional investors and private individuals—in other words, the State and virtually all of its citizens.

Consequently, the review covers a wide range of governance topics, including directors and board composition, independence, board sub-committees including the audit committee, nomination and remuneration of directors, internal control and risk management. The review assesses the extent to which companies disclose compliance with important provisions of the Combined Code related to these topics.

Key findings from the 2010 report

One of the main findings of the review was the number of companies that report that they are fully compliant with the Combined Code. In the first two years of our review, around one third of companies claimed to be fully compliant. Last year (based primarily on 2007 and 2008 annual reports) the number of companies claiming full compliance increased to around 50%; this year, the number dropped back down to 36%. This finding, predictably, received the most media attention.

Although this finding may be interpreted as indicating that companies are now less compliant, an alternative explanation—that companies are being more transparent about their levels of compliance—seems more plausible.

We can however say that, by and large, companies comply with the vast majority of the Code's provisions. In fact, a report commissioned by the ISE and the Irish Association of Investment Managers (IAIM) reported “a high level of compliance by Irish listed companies with the Code during the 2008 financial year”—and looking at all of the individual compliance requirements across all companies, it is correct to say that a majority of compliance requirements are met. Nonetheless, it is still the case that only a minority of companies—by their own assessment—manage to comply with *all* requirements.

Although the Code is designed to allow companies to “comply or explain,” this was intended to allow companies to either comply with the exact requirement of the Code, or explain how they have implemented a governance mechanism better suited to meeting the needs of the company and its shareholders. The “explain” option was never, we believe, intended to allow companies to opt-out of complying.

Exacerbating this situation is, arguably, a failing in the Code and the compliance framework for listed companies, in that there is no clear distinction between minor and major compliance requirements. Clearly, a company that is virtually compliant except for some minor disclosure items, is in a different camp from a company that is 95% compliant but chooses not to have an independent board, or doesn't properly disclose how it manages the risks in the business. Our research shows that some of the areas where companies are not compliant are significant issues like not having an internal audit function or around board independence issues.

In relation to independence, 23% of companies did not have a majority of independent non-executive directors for the full financial year. Added to this, many companies made it difficult to determine which directors were independent, and in general the quality of disclosures in Irish listed companies—and indeed in those in many other jurisdictions—could be significantly improved. Other principal findings from our review include:

- 36% of companies did not disclose the **terms and conditions of appointment** of non-executive directors
- 33% of companies did not disclose that there was appropriate **evaluation of chairman's performance**
- 28% of companies did not disclose that there is a clear **division of responsibilities between chair and chief executive**
- 56% of companies did not disclose that any member of their audit committee has **recent and relevant financial experience**

Recommendations from the review

Regardless of the regulatory framework, it is clear that it is the behaviour of boards and in particular their leaders that ultimately determine the corporate governance culture of a company.

Our review includes significant editorial sections, highlighting the implications of the findings, and incorporating our recommendations for changes to improve governance amongst Irish companies. These recommendations fall into a number of areas.

The quality, structure and organisation of boards

A fundamental requirement of good governance is to have a board that is balanced and sufficiently independent—diverse but cohesive—and which performs at an optimum level to ensure that the interests of the company and shareholders are protected.

This requires a board that has a sufficient level of genuinely independent non-executive directors, and sufficient skills and expertise, to ensure that the conflicts of interest between shareholders and management are properly managed.

The results of our survey indicate that there is room for improvement in the levels of independence on boards of Irish listed companies, and that the level of essential skills, such as “recent and relevant financial experience” (as required by the Code) is either not sufficient, or needs much better disclosure.

The requirement for a majority independent board should be mandatory, and regulators should have an active role in ensuring that boards possess all of the required skills, particularly for banks and other financial institutions. The often stated assertion that there are not enough appropriately qualified directors in the Irish market should be challenged, not least because the increasing exposure of Irish companies to international markets means that Irish companies should seriously consider the level of international representation on their boards.

The role of the chairman

The chairman's role is clearly defined in the guidance, and entirely distinct from that of the chief executive or any other director. The chairman is, according to the Combined Code, "responsible for leadership of the board, ensuring its effectiveness on all aspects of its role, and setting its agenda." This goes much further than a common misconception of the role, where the chairman is responsible for little more than chairing board meetings. The chairman of a well-governed board should bear ultimate responsibility for the structure, composition, balance, organisation, and resourcing of the board, and for ensuring that it is effective in balancing the interests of the shareholders with the—often conflicting—interests of the executive management of the company.

Given that a strong chair is vital to a successful board, the requirement to clearly separate the roles of chair and chief executive so that they are occupied by different people, with clearly distinct responsibilities and terms of reference, is essential for listed and regulated companies and should be mandatory.

Regulatory framework

Much of the regulatory framework is, as I mentioned previously, optional on a "comply or explain" basis. The suggestion that much of this should be made mandatory has gained acceptance in many quarters. However, overall there is not a lack of regulation in Ireland; if anything, there is a lack of compliance with regulation and a lack of enforcement and sanctions. There are clear indicators now that there is an appetite for change and for increased enforcement—this is to be welcomed.

There are also multiple regulators involved in the regulation of listed companies in Ireland—although this is not in itself a problem, it increases the need for clarity in the roles of the regulators and in the expectations of how the regulators will enforce compliance and sanction non-compliance.

Reporting and disclosure of risk and control

Risk management and internal control are vital management-level governance mechanisms that should provide assurance that an organisation's strategic objectives are being met and its stakeholders' interests are being protected.

Our report highlights the lack of detail in annual reports in relation to risk management and internal control, and events of the past two years have indicated that these processes are not adequately understood at board level. The Financial Regulator's consultation paper has suggested a requirement that Boards set the risk appetite for the institution and monitor adherence to this. In the US, legislation requires that boards disclose significant details about their company's risks and controls, and certify that these controls are operating effectively. Ultimately though, regardless of the legislative requirements, it is essential that boards understand the risks faced by their companies, and ensure they are properly disclosed.

In particular, the apparently prevalent use of standardised disclosure text, where the wording of the disclosures varies little year-on-year — or even across companies — seems to indicate that

companies are more concerned about “checking-off” compliance requirements than providing detailed, relevant information to shareholders and other users of annual reports, and this practice should be challenged.

Consequences of our recommendations

The foreword to our 2009 report noted that “failure to meet the expectations of the global markets will ultimately destroy the trust of international investors in Irish listed companies.” Our 2010 report reinforced this point and noted that “we need to be a leader in the development and enforcement of standards both in listed companies and public interest bodies such as state companies.”

It is clear from reading the international press that governance scandals in Ireland, coupled with the severe downturn in our economy, have caused our reputation in international markets to suffer. The role of the legislature in addressing this should, we believe, lie in strengthening our regulatory environment to ensure that Ireland not only catches up with other jurisdictions in the EU and further afield, but moves ahead. This can only be done by putting in place the governance mechanisms that achieve this goal without damaging our companies’ competitiveness in international markets, and putting in place a regulatory framework focused on monitoring compliance and enforcing it with strong and effective sanctions.

The Combined Code on Corporate Governance is due to be renamed later this year to the “UK Corporate Governance Code”—highlighting the fact that Ireland, exceptionally in the EU, lacks its own specific corporate governance code for listed companies. This is a unique opportunity for Ireland to establish our own corporate governance framework, and establish the country as a standard bearer for international corporate governance, for the ultimate benefit of shareholders and the economy.