Paper P3
Performance Strategy

The UK's corporate governance code has been revised – and it features a number of significant changes of emphasis that are relevant to P3

By the examiner for P3

The UK's revised guidance on corporate governance matters came into force for accounting periods starting on or after 29 June 2010. The most obvious revision is that the document's full title is now "The UK corporate governance code". Previously it was called "The combined code on corporate governance". This change is probably intended as a reminder to non-UK companies listed on the London Stock Exchange that some provisions apply to them. The P3 syllabus is not country-specific. Most of the issues arising in corporate governance are common to any setting where shareholders delegate the management of their investments to a board of directors, so the content of the new code should be treated as a credible guide to good governance generally.

The P3 paper may include questions that are inspired by the code, while suggested answers may refer to it in support of any assertions made. This does not mean that you should memorise the document. Exam questions will not test your ability to reproduce chunks of text. The code offers advice on specific matters and is not intended as a detailed check list. Questions at this level should reflect the real world and the code is only one source of guidance. But it is worth reading in detail, of course, and it can be downloaded free from the Financial Reporting Council (FRC) website (www.frc.org.uk). Although it covers 35 pages, the document is laid out in such a way that there's a lot of blank space, so getting through it is not a major task.

There is another document on the FRC's site that's well worth reading: a report entitled "Revisions to the UK corporate governance code" highlights the changes that have been introduced. Most interestingly, it covers areas where problems have arisen in practice, thereby providing an idea of the most important and contested issues. The code, which was written as a response to the corporate scandals that occurred in the 1980s and 1990s, is fundamentally a practical document designed to deal with the tensions that have been shown to create problems. Its name has changed over the years (it was originally the Cadbury report) and it has been supplemented by parallel documents such as the Turnbull guidance on risk management and internal control, the FRC's guidance on audit committees and the Higgs report (under review at the time of writing), which provides advice for non-executive directors.

'The code is not intended as a detailed check list. Exam questions at this level should reflect the real world and the code is only one source of guidance'

The code has five main sections, covering leadership, effectiveness, accountability, remuneration and relations with shareholders. There are two new principles dealing with leadership:

- The chairman is responsible for leadership of the board and ensuring its effectiveness in all aspects of its role.
- As part of their role as members of a unitary board, non-executive directors should constructively challenge and help to develop proposals on strategy.

There are also two new principles in the section on effectiveness:

- The board and its committees should have the appropriate balance of skills, experience, independence and knowledge of the company to enable them to discharge their respective responsibilities effectively.
- All directors should be able to allocate sufficient time to the company to discharge their responsibilities effectively.

The addition of these four principles suggests that achieving good governance requires guidance in areas such as ensuring that the board provides sound leadership and that its members work effectively. It shouldn't be a huge surprise, therefore, if an exam question were to require you to discuss, say, a scenario in which the board structure might be changed in order to enhance its leadership

Paper P3 Performance Strategy

of the company. The insertion of these new principles indicates that concerns have been raised that some directors do not have the required balance of skills to discharge their duties properly. But it also underlines the fact that the code is not intended to be a prescriptive set of detailed rules. It should, for example, have been obvious before its publication that the non-executive directors have a role to play in challenging the strategic direction being proposed by their executive colleagues. The new principle in question has clearly been designed to remind the non-executives of that responsibility and to stress its importance.

The spirit of the code is more important than the letter, so the new principle that all directors should be able to allocate enough time to the company is not reinforced by a statement that the job will entail, say, 40 hours' work a week. Instead, it is supported by guidance that reflects the differing responsibilities of the chairman, the other non-executive directors and the executive directors.

Several of the code's existing principles have been revised. The most significant changes are as follows:

- The board is responsible for the long-term success of the company. Previously there was no reference to sustainability.
- The chairman has an added duty to achieve a culture of openness and debate, and to ensure that adequate time is given to discussion.
- Boards must now also consider the benefits of diversity – eg, improving the gender balance – when making appointments.
- Boards are now responsible for maintaining risk management systems, as well as sound internal control systems.
- The chairman must ensure that all directors are made aware of shareholders' concerns.

The best way to use this material when studying is to consider how it might affect companies in practice. This is partly because it's always useful to think in those terms – the requirements in exam questions are designed to make you do exactly that. It's also possible that a question will be inspired by such revisions. If you have already considered their implications, you will have an advantage if that issue is ever examined.

You need to remember that corporate governance is a complex area and there will never really be a "correct" answer to a question on it. For example, suppose a question describes a scenario in which a company's board lacks diversity and has an exclusively male membership. Say it asks about the pros and cons of correcting that bias. It would be easy to argue that gender bias is discriminatory, morally repugnant and unlawful in many countries. Such arguments would be valid, but you would be unlikely to gain many marks by using them alone. It would be necessary to think beyond the most obvious and emotive issues.

'You need to remember that corporate governance is a complex area and there will never really be a "correct" answer to a question on it'

Developing an argument on a corporate governance issue could involve thinking through the implications of the problem for the company. For example, the biggest cost to the business may be reputational rather than any statutory penalty directly associated with the unlawful restriction of board places to men. It would almost certainly be difficult to prove that a female candidate had been rejected because of her gender, since the nomination and selection committee could simply argue that she wasn't the best candidate. If her claim is successful, the company may be fined, but that financial damage is unlikely to be material. Yet there could be a significant cost if the company's employment practices demotivate its female employees and alienates its female customers. Identifying an appropriate remedy will also require some care. For example, how should the board respond if the female applicants for a particular vacancy are less capable than their male competitors? Should the selection decision put diversity before competence?

Drawing on ideas you have obtained from reading the code may help you to answer a question on governance but, as the above example shows, it may be hard for you to reach a clear-cut conclusion. This underpins the idea that the key to successful exam preparation is to think through challenging problems and rehearse the practicalities of supporting a position.

Further reading P Collier and S Agyei-Ampomah, *CIMA Official Learning System – Performance Strategy*, CIMA Publishing 2009.