

TRANSPORT FOR LONDON

AUDIT COMMITTEE

**SUBJECT: TFL'S COMPLIANCE WITH THE FRC'S UK CORPORATE GOVERNANCE CODE**

**DATE: 7 MARCH 2012**

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**1 PURPOSE AND DECISION REQUIRED**

- 1.1 The Financial Reporting Council's (FRC's) UK Corporate Governance Code (formerly the Combined Code) sets out standards of good practice in relation to board leadership and effectiveness, remuneration, accountability and relations with shareholders. The attached report sets out the findings of a review by Internal Audit to benchmark TfL against relevant sections of the FRC's UK Corporate Governance Code.
- 1.2 The Committee is asked to note the paper.

**2 BACKGROUND**

- 2.1 TfL undertakes an annual review of its corporate governance arrangements in accordance with the CIPFA/SOLACE corporate governance framework and publishes an Annual Statement of Corporate Governance Assurance as required under that framework.
- 2.2 The FRC maintains the UK Corporate Governance Code, which is applicable to listed companies. Other organisations are encouraged to view the Code as best practice. Therefore, it was proposed that TfL Internal Audit would undertake a benchmarking review of TfL's compliance with the relevant parts of the Code.
- 2.3 The results of Internal Audit's review are set out in Appendix 1. This work forms part of the Board Effectiveness Review, which was agreed by the Board at its meeting of 2 February 2012.

**3 TFL'S COMPLIANCE WITH THE UK CORPORATE GOVERNANCE CODE 2010**

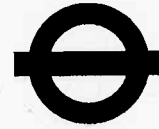
- 3.1 Internal Audit's review did not identify any significant issues, but did identify a number of areas where governance arrangements could be enhanced in order to comply with the Corporate Governance Code. The recommendations in the report are accepted by TfL and will be implemented.

**4 RECOMMENDATION**

- 4.1 The Committee is asked to NOTE the paper.

## 5 CONTACT

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## **TfL's Compliance with the UK Corporate Governance Code 2010**

### **Introduction and Scope**

The Deputy Chairman of TfL recommended, and the Board agreed, that a benchmarking review should be carried out of TfL's corporate governance arrangements against the relevant requirements of the Financial Reporting Council's (FRC's) UK Corporate Governance Code 2010 (hereafter 'the Code').

It was recognised from the outset that many elements of the Code are not relevant to TfL. In particular large parts of the Code deal with relations with shareholders, which TfL does not have. Also, TfL's Board is made up of non-executive Members appointed by the Mayor, rather than a mixture of executive and non-executive directors elected via a nomination committee. However, other aspects of the Code are relevant to TfL and, in order to ensure that TfL's governance arrangements are best practice, it was seen as beneficial to benchmark TfL against these relevant aspects of the Code.

Internal Audit was asked to carry out the benchmarking review.

### **Background**

The Code is applicable to all companies with a Premium Listing<sup>1</sup> of equity shares on the London Stock Exchange and details the key components of effective board practice and robust governance. The financial crisis of 2008-

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<sup>1</sup> A Premium Listing is only available to equity shares issued by trading companies and closed and open-ended investment entities. Issuers with a Premium Listing are required to meet the UK's rules which are higher than the EU minimum requirements.

09 triggered a global reappraisal of governance systems, and in the UK, the FRC responded by publishing its revised Code in June 2010.

The Code is divided into five 'Sections': Leadership, Effectiveness, Accountability, Remuneration and Relations with Shareholders. Each Section contains 'Main Principles' – each a short, high-level statement of how to comply with the Code, mostly aimed at the board. How each Main Principle should be complied with is further detailed in 'Supporting Principles', the requirements of which are still further explained in 'Code Provisions'. However, in addition to following the letter of these Provisions, companies are also encouraged to follow the spirit of the Code.

TfL is a statutory body created by the Greater London Authority Act 1999 (hereafter 'GLA Act') and one of the four bodies that comprise the GLA Group.

Under the GLA Act, TfL has a responsibility for ensuring that its business is conducted lawfully, and that public money is safeguarded and properly accounted for. TfL also has a duty under the Local Government Act 1999 to make continuous improvement in the way in which its functions are exercised.

In discharging its duties under the GLA Act, TfL undertakes an annual review of its corporate governance arrangements in accordance with the joint Chartered Institute of Public Finance & Accountancy (CIPFA) and Society of Local Authority Chief Executives and Senior Managers (SOLACE) corporate governance framework 'Delivering Good Governance in Local Government'. This defines best practice for local authorities in developing and maintaining a code of governance. As required under this framework, TfL publishes an Annual Statement of Corporate Governance Assurance.

However, in seeking to benchmark TfL's corporate governance arrangements against the relevant aspects of the Code, management are also discharging their duty under the Local Government Act. Other organisations are encouraged to view the Code as best practice, and in striving to adhere to it; where relevant, TfL is exceeding the statutory requirements for a governmental body.

## **Findings**

The first item to report is TfL's commitment to ensuring robust corporate governance arrangements.

No significant issues were identified during the review. There are two elements of the Code where TfL could enhance its governance arrangements. However, in both instances, these have already been identified as areas where improvements could be made, and management are considering actions to make current arrangements more robust. There are seven other Provisions where TfL does not fully meet the requirements of the Code. However, these Provisions are relatively minor and are not onerous, and mostly relate to disclosures in the Annual Report. All findings are discussed below.

## **Scope for improvement against the Main Principles of the Code**

### Provisions B.6.1 & B.6.2: Review of effectiveness of the Board and its Committees and Panels

The Code states in its Main Principle B.6 that 'The board should undertake a formal and rigorous annual evaluation of its own performance and that of its committees and individual directors'. Provision B.6.1 requires disclosure of the evaluation process to be included in the annual report. B.6.2 goes further and requires that FTSE 350 companies facilitate an external evaluation at least every three years.

Historically, the TfL Board has not undertaken an annual evaluation of its own performance, and nor has TfL employed a consultant to perform an external review. There has, therefore, been no disclosure in the Annual Report.

However, a review of the functioning of TfL's Committees and Panels was conducted by the Deputy Chairman in 2009, with a follow up review taking place in 2010. More recently the Deputy Chairman has proposed a structured review by an external consultant of Board effectiveness, and this was approved by the TfL Board on 2 February 2012, and will now be taken forward.

While TfL does not currently fully adhere to these Provisions, by initiating this review steps have already been taken to address this.

In order to fully comply with Provisions B.6.1 and B.6.2 of the Code TfL should disclose the evaluation process in its annual report. A Board effectiveness review should be carried out annually going forward, including an external review every three years.

### Provision C.2.1: Risk Management

In Provision C.2.1, the Code states that 'the board should, at least annually, conduct a review of the effectiveness of the company's risk management .... systems...'.

There is currently some senior level consideration of risk. Risk management is discussed at Audit Committee (AC) meetings, although recently this has been irregular, and risk items have only been considered twice at AC meetings since June 2010. Historically the Chief Officers have reviewed the TfL strategic risks annually, although this has not been done since September 2010. In addition, Internal Audit, in forming the Director's annual Internal Audit opinion, carries out regular reviews of risk management across TfL which are reported to the AC.

However, the above activity does not fully meet the requirements of the Code. Management have recently produced a proposal, submitted to the February 2012 Assurance Delivery Group (ADG), to produce quarterly risk reports. These reports are to include both strategic and directorate level risks, and will be included as agenda items at the Rail & Underground (R&U) and Surface Transport (ST) Board meetings which are attended by the relevant Chief Officers. Also under the proposal, consolidations of the R&U, ST and Corporate quarterly risks reports will be reviewed by the Finance Leadership

Team and submitted to the Finance & Policy Committee and the Audit Committee each quarter.

These proposals appear to provide a sensible way forward that will ensure greater compliance with this provision of the Code. As such, we recommend that the proposals should be adopted. In addition, we recommend that management should give consideration to submitting an annual risk report to the TfL Board.

### **Relevant Provisions where TfL does not fully adhere to the Code**

#### Provision A.1.2: Frequency of, and attendance at, Board meetings

This Provision states that the annual report 'should also set out the number of meetings of the board and its committees and individual attendance by directors.' TfL's most recent Annual Report makes no reference to either the number of Board and Committee meetings or the attendance levels.

As noted above, the 'board' that the Code refers to is a different body from TfL's Board, and as such these requirements are arguably less critical to TfL than to a listed company. We also note that there are a large number of meetings of the Board, its Committees and Panels and that attendance is recorded in the minutes for all of those meetings. The proceedings of the Open agenda for those meetings are also published.

Nonetheless, we recommend that, in striving to achieve best practice, management gives consideration to providing additional consolidated information about the number of meetings and the attendance of members..

#### Provision B.3.2: Terms of appointment of board members

The Code requires that the letter of appointment for non-executive directors should set out the expected time commitment, and require an undertaking that the individual will have sufficient time to honour this commitment. Since all TfL Board Members are non-executive, this Provision can be considered to be of some relevance. The TfL letter of appointment does not specify any time commitment expected, although does contain a statement that Board Members are expected to 'regularly attend meetings'.

Management should consider whether it would be appropriate to revise the terms of the letter of appointment for Board Members to include a more explicit reference to the expected time commitment.

#### Provision C.3.2: Audit committee terms of reference

This Provision specifies that the audit committee's terms of reference should include reference to, amongst other items, responsibility 'to develop and implement policy on the engagement of the external auditors to supply non-audit services'. The terms of reference of TfL's Audit Committee simply state that it will 'review TfL's non-audit services policy and monitor its application'.

While this is only a minor issue, we feel that, amidst a trend of increased scrutiny over non-audit services provided by external auditors, making the role

of the Audit Committee more prominent would seem appropriate. We recommend therefore that management consider amending the terms of reference of the Audit Committee to follow the wording in Provision C.3.2, so far as is applicable to the circumstances of a non-executive Board.

#### Provision C.3.7: Non-audit services

The Code states that the annual report should explain how auditor objectivity and independence is safeguarded where the external auditor provides non-audit services. In 2011, TfL's external auditors KPMG provided £0.1m of non-audit services, against a total fee of £2.3m. In 2010, these figures were £0.4m and £2.0m respectively. The TfL Audit Committee regularly monitors non-audit services provided by KPMG, and KPMG's annual declaration on independence and objectivity, and this is recorded in open minutes. However, there is no statement made in the Annual Report in relation to these matters.

As noted above, in view of the current climate regarding non-audit services, we recommend that TfL follow best practice and adopt Provision C.3.7.

#### Provision D.1.1: Upper bonus limits

This Provision states that, 'in designing schemes of performance-related remuneration for executive directors, the remuneration committee should follow the provisions in Schedule A'.

Schedule A requires that upper limits for bonus payments are set and disclosed in the Annual Report. TfL Chief Officers are entitled to bonus payments of up to 30%, and the Commissioner up to 50%. The Remuneration sections in the 2010/11 and 2009/10 Annual Reports state that the Commissioner and all Chief Officers waived their performance awards, but no statement is made regarding the upper limits for these waived awards. It should be noted that the upper limits were disclosed in 2008/09, which was the last time that performance awards were paid.

In keeping with the spirit of the Code, we recommend that management give consideration to whether the upper limits should be disclosed even in years where the payment awards are waived.

#### Provision D.2.1: Use of remuneration consultants

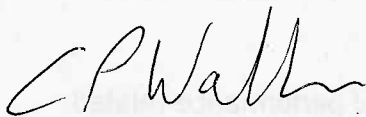
The Code states that 'where remuneration consultants are appointed, a statement should be made available of whether they have any other connection with the company'. TfL engaged Towers Watson to benchmark the remuneration of Chief Officers against a peer group of other companies, and this is disclosed in the Remuneration section of the 2010/11 Annual Report. However, there is no statement indicating whether Towers Watson has any other connection with TfL, either in the Annual Report or elsewhere.

We recommend that management should review Provision D.2.1 and give consideration to making the requisite statement available.

**Conclusion**

TfL already has significant and appropriate governance arrangements in place as required by the CIPFA/SOLACE framework. This review has highlighted a number of areas where TfL may wish to amend its governance arrangements in order to achieve compliance with the Code, with only those relating to review of board effectiveness and review of risk management being of any significance.

Kind regards



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