



Governance *in brief* 2013 holiday briefing on the latest governance developments

Headlines

- FRC seeks consistency in the reporting of exceptional items.
- FRC guides Audit Committees on oversight of materiality judgements and booking of errors.
- Changes to the Listing Rules remuneration disclosure requirements.
- “Some progress but more still to do” – the FRC issues its third annual report “Developments in Corporate Governance 2013”.
- Europe lays out stall on audit tendering.

2013 Audit Committee Reporting Season

Since we published the definitive guide for audit committee members on all the 2013 changes at the end of October (*‘Governance in focus – The 2013 audit committee reporting season: New rules or a new regime?’* which is available from www.deloitte.co.uk), inevitably there have been a few last minute announcements to communicate!

Audit committee members should refer to that publication and this briefing note for the December 2013 reporting season.

FRC seeks consistency in the reporting of exceptional items

The Financial Reporting Council issued a reminder to Boards on 13 December 2013 on the need to improve the reporting of additional and exceptional items by companies and ensure consistency in their presentation.

Richard Fleck, chairman of the FRC’s Conduct Committee and chair of the FRRP, said:

“It is essential that investors should be able to understand and rely on the trends in the profitability of companies. This announcement draws attention to the importance of providing information in a way that enables users to assess the quality of a company’s profitability. It is a timely reminder as directors consider their response to the Corporate Governance Code principle that the annual report and accounts as a whole should be fair, balanced and understandable.”

The FRRP believes that, in judging which items to include, companies should have regard to the following:

- The approach taken in identifying additional items that qualify for separate presentation should be even handed between gains and losses, clearly disclosed and applied consistently from one year to the next. It should also be clearly distinguished from alternative performance measures used by the company that are not intended to be consistent with IFRS principles.
- Gains and losses should not be netted off in arriving at the amount disclosed unless otherwise permitted.
- Where the same category of material items recurs each year and in similar amounts (for example, restructuring costs), companies should consider whether such amounts should be actually included as part of underlying profit.

- Where significant items of expense are unlikely to be finalised for a number of years or may subsequently be reversed, the income statement effect of such changes should be similarly identified as additional items in subsequent periods and readers should be able to track movements in respect of these items between periods.
- The tax effect of additional items should be explained.
- Material cash amounts related to additional items should be presented clearly in the cash flow statement.
- Where underlying profit is used in determining executive remuneration or in the definition of loan covenants, companies should take care to disclose clearly the measures used.
- Management commentary on results should be clear on which measures of profit are being commented on and should discuss all significant items which make up the profit determined according to IFRS.

For further information: <http://www.frc.org.uk/News-and-Events/FRC-Press/Press/2013/December/FRC-seeks-consistency-in-the-reporting-of-exceptional-items.aspx>

Deloitte view

- On the international stage, the UK stands apart in the myriad ways that companies present exceptional items – with columns, boxes, underlying, business performance, organic or other labelling of adjusted measures – no doubt because the thriving capital market in London demands guidance on company specific underlying trend information.
- It is clearly late in the day to adjust analyst expectations for December year ends in relation to underlying profits but this is a helpful reminder about transparency of disclosure given the lack of consistency in the market.

FRC guides Audit Committees on oversight of materiality judgements and booking of errors

The Financial Reporting Council has published a report on the auditor's consideration and application of materiality together with guidance for audit committees encouraging them to deepen their understanding of the materiality judgement made by auditors and its application. This guidance on materiality addresses an area of particular interest to investors given its potential impact on the scope of an audit and the extent of the audit work performed.

The report, the first of a series of Audit Quality Thematic Reviews, makes a number of recommendations to audit committees including furthering their understanding of:

- the basis for the materiality levels set including, in particular, how these reflect the needs and expectations of users of the entity's financial statements;
- how materiality levels are expected to affect the level of audit work performed;
- the benchmarks used by their auditors in determining materiality levels and why these are considered to be appropriate;

- the reasons for and the effect of any increases in materiality levels, including whether their auditors believe that the needs and expectations of users of the entity's financial statements have changed and the likely impact on the level of audit work undertaken;
- how materiality levels affect the extent of audit work undertaken in significant areas;
- how auditors are ensuring that materiality is being determined appropriately at group and component levels;
- why management have not adjusted the financial statements for uncorrected misstatements brought to their attention by the auditors and instruct management to make the relevant adjustments where appropriate;
- whether disclosure omissions reported to them by the auditors have arisen through error or a specific management judgment and assess whether the inclusion of the disclosures concerned is likely to provide material information to users of the financial statements;
- where actual results are worse than forecast or significant events arise near the year-end, whether the materiality levels set need to be revised and the nature and extent of the audit work performed remains appropriate; and
- whether any changes subsequently made to the materiality levels and reporting threshold initially advised have been reported to them.

For further information: <http://www.frc.org.uk/News-and-Events/FRC-Press/Press/2013/December/FRC-issues-report-on-auditor-s-materiality-judgeme.aspx>

Deloitte view

- The new enhanced auditors' report will increase the investor focus on audit materiality and audit committee chairs may find themselves receiving questions on the application of materiality in the judgements made at their company's AGM. This report equips audit committees with the right questions to ask their auditors to gain a better understanding and prepare for questions from investors should they in fact be posed.
- The FRC re-emphasises the need for audit committees to instruct management to book adjustments where appropriate.

Changes to the Listing Rules remuneration disclosure requirements

In a welcome move, the Financial Conduct Authority has amended the Listing Rules in response to the new directors' remuneration report and narrative reporting regulations in order to ensure that any duplication in relation to directors' remuneration is kept to a minimum and that unnecessary requirements are not imposed on UK incorporated listed companies.

All of the disclosures relating to remuneration, currently contained in LR 9.8.8, have been removed with the exception of what was LR 9.8.8 (9). This provision now becomes LR 9.8.8 and requires the disclosure of the unexpired term of any director's service contract where that director is proposed for election or re-election at the forthcoming annual general meeting. This rule remains as it is applicable to both UK and overseas companies with a premium listing and therefore maintains the current requirements for overseas companies.

The new Listing Rules will be effective from 13 December 2013 and apply to all companies with financial years ending on or after 30 September 2013 that have not published their annual financial report before 13 December 2013. Companies already preparing their report can continue to publish the report after 13 December 2013 in compliance with both the existing Listing Rules and the new remuneration reporting requirements if they choose to do so.

For further information: <http://www.fca.org.uk/static/documents/policy-statements/ps13-11.pdf> and in the Deloitte publication "The Directors' Remuneration Report: A practical guide to the new Regulations" available from www.deloitte.co.uk.

Deloitte view

- The removal of most of the requirements in LR 9.8.8 avoids the potential for duplication and confusion between the requirements of the new remuneration report regulations and the current Listing Rules. We therefore welcome removal of these rules.
- We also welcome the decision to make the new rules effective from 13 December which means that any remuneration reports published after this date need only comply with the new directors' remuneration reporting regulations.

"Some progress but more still to do" – the FRC issues its third annual report "Developments in Corporate Governance 2013"

The FRC has issued its third Developments in Corporate Governance Report which covers three main topics:

- the quality of compliance with, and reporting against, the UK Corporate Governance and Stewardship Codes and on regulatory and other developments in the UK listed sector in 2013;
- the FRC's assessment on the quality of engagement between companies and investors; and
- areas where the FRC considers further efforts are needed to bring necessary improvements in governance and leadership.

Compliance and reporting

Reported compliance with the Code remains high, with the majority of companies either complying with all, or all but one, of its provisions. However, the FRC comments that these high compliance levels do not reduce the need for companies to provide a meaningful explanation when they choose not to follow the Code.

Quality of engagement

The report notes that there are some encouraging signs that more engagement on a wider range of issues is taking place between large companies and their major shareholders. However, there are concerns about the quality of engagement at mid-market companies and an emerging "engagement deficit". The FRC believes that the main priority must be to encourage and assist signatories to the Stewardship Code to deliver on the commitment they have given, and to monitor whether they are doing so.

Further efforts needed

- **Reporting by mid- and small-cap companies** – the FRC believes that, in general, the reporting to shareholders by these companies is less informative than that of larger companies. While the FRC recognises that there are greater resources available to larger companies, the FRC does not believe that the size of a company should be a determining factor in the level of transparency investors can expect.
- **Succession planning** – boards need to do more to anticipate the need for changes rather than being purely reactive. For these reasons, the FRC will undertake a project in 2014 with the aim of identifying and spreading good practice in succession planning and, more generally, how the nomination committee can play its role effectively.
- **Board evaluation** – some companies have raised concerns about the variable quality of service provided by external facilitators. The FRC has published data from Practical Law which shows that 51 different facilitators were appointed by FTSE 350 companies in the period under review. On the same topic, the FRC is encouraging companies to disclose the main actions that were agreed following the board effectiveness review and how those actions have been or will be implemented.
- **Election of directors** – the FRC has reviewed a sample of 50 AGM notice papers to assess the extent to which companies were setting out the reasons why the company believed that the directors should be re-elected. The FRC considers that the majority of companies could do more to explain to investors in the AGM papers how individual directors contribute to the effectiveness of the board as a whole.

Possible changes to the Code in 2014

- **Responding to the recommendations from the Competition Commission** – the FRC is considering the recommendations in relation to audit committee reporting and to implement the advisory shareholder vote on the audit committee report. In addition, the FRC will review whether to retain the “comply or explain” tendering provision in the Code in light of the Competition Commission’s decision on mandatory tendering.
- **Website publication of the full corporate governance statement** – the FRC is considering whether the Code should be amended to allow companies to place the full corporate governance statement on the website, with an edited version containing the disclosures most relevant to investors in the annual report.
- **Remuneration** – the section of the Code dealing with remuneration will be updated in light of the new legislative requirements on reporting and voting on directors’ remuneration.

For further information: <https://frc.org.uk/News-and-Events/FRC-Press/Press/2013/December/FRC-encourages-better-comply-or-explain-disclosure.aspx>

Deloitte view

- We welcome this report from the FRC and support the key areas of focus for 2014. After several years of re-shaping disclosures in company annual reports, the focus is shifting to facilitating better engagement with shareholders and to governance effectiveness.
- We continue to have concerns about the level of disclosures required for all premium listed companies, not just the larger companies. While it is difficult to disagree with the principles, the costs of accessing capital markets in London and the costs of ongoing compliance are high.

Europe lays out stall on audit tendering

The European Parliament (JURI Committee) negotiators, the Lithuanian Council Presidency representing the 28 European Union Member States and the European Commission today reached a preliminary agreement on future EU audit legislation. We understand that the preliminary agreement includes 10 year mandatory firm rotation for public interest entities, with a Member State option to extend this up to 20 years in the case of tendering or 24 years in the case of joint audit.

Subject to Member State approval, the reforms will go through a detailed legal and language review, before being submitted for a vote before the plenary European Parliament, currently scheduled for 3 February 2014, and then for formal approval by the Council shortly thereafter.

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If you would like further details about the Deloitte Academy, including membership enquiries, please email enquiries@deloitteacademy.co.uk

UK Centre for Corporate Governance

For further information on corporate governance matters please click here

<http://www.corpgov.deloitte.com/site/uk/>

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