



## Governance *in brief* FRC consults on changes to the UK Corporate Governance Code

### Headlines

Building on earlier consultations in October and November 2013, the FRC is proposing the following changes:

- Remuneration: Boards should focus on the long term success of the company when setting remuneration policy and include clawback provisions.
- AGM resolutions: Companies should set out how they intend to engage with shareholders on any resolutions which have not received a significant proportion of votes in support.
- Going concern AND statement of ongoing viability: It is proposed that the annual report includes two distinct statements – the board's confirmation of the appropriateness of the going concern basis of accounting and a broader assessment by the board of the company's ongoing viability.
- There are no major changes to the FRC's earlier proposals on principal risks and the board's monitoring of the risk management system. Accordingly, the recommendation in the previous draft integrated guidance to explain actions taken to remedy any failings or weaknesses identified remains.

### Introduction

The FRC is consulting on proposed changes to the UK Corporate Governance Code which, if implemented, will apply to reporting periods beginning on or after 1 October 2014. The consultation is the final part of its two year review of the Code and follows earlier consultations on directors' remuneration (October 2013) and risk management, internal control and the going concern basis of accounting (November 2013).

### Directors' remuneration

#### Focus on long-term success

In order to provide clarity on the overall objective that remuneration policies should be designed to deliver long-term benefit to the company, the 'main principle' D.1 will now state that "Executive directors' remuneration should be designed to promote the long-term success of the company. Performance-related elements should be stretching and rigorously applied."

The principle of avoiding more than necessary, previously in principle D.1, is retained in the 'supporting principle'.

#### Provisions on clawback and withholding of remuneration

Clawback is strongly supported by investors and the FRC is proposing to include a provision relating to clawback in the Code:

"Schemes should include provisions that would enable the company to recover sums paid or withhold the payment of any sum, and specify the circumstances in which the committee considers it would be appropriate to do so".

Under the 'comply or explain' principle, if a company does not have provisions to clawback or withhold remuneration it will be a requirement to explain why this is the case.

#### Votes against AGM resolutions

At present, the Code does not explicitly state how boards should respond if the company fails to obtain at least a substantial majority in support of a resolution on remuneration. There was some concern expressed by respondents that singling out remuneration in this way may send out a signal that this is considered more important than engagement on strategy, board composition and other important matters.

The proposal is therefore to add a provision to Section E.2 which deals with the constructive use of the AGM, covering all resolutions, not just those relating to remuneration. The intention is that companies should set out how they intend to engage with shareholders to assess their concerns, not how they intend to address these concerns. The Code does not define what constitutes a 'significant proportion' and this will be left to each company to assess.

### **Deloitte comment**

With the mooted advisory vote on the audit committee report as part of the Competition and Market Authority's implementation of the Competition Commission's Statutory Audit market inquiry, the proposal to explain how a company intends to engage with shareholders to address their concerns will have broader relevance, extending also to the whole area of directors' appointments which is an increasing area of focus with companies having to explain at much greater length director biographies, skills and performance in the annual re-election process.

The FRC has not gone as far as asking boards to explain in the next annual report what action was actually taken but boards might wish to do this as a natural follow on.

### **Remuneration committee membership**

Views were sought on whether changes to the Code were required in order to deter the practice of executive directors serving as members of a remuneration committee in another listed company. There was very little support for a recommendation against this practice as there is little practical evidence that current practices are creating any governance issues and therefore the FRC does not intend to take this proposal any further.

### **Conflicts of interest**

The FRC is proposing to amend the supporting principle in D.2: Procedure, to remove any potential ambiguity in relation to the remuneration committee consulting the chief executive about proposals relating to other executive directors. The amended principle now reads:

"The remuneration committee should take care to recognise and manage conflicts of interest when receiving views from executive directors or senior management, or consulting the chief executive about its proposals. The committee should be responsible for appointing any consultants in respect of executive directors' remuneration".

### **Other changes**

The FRC is proposing a number of changes to Schedule A – The design of performance-related remuneration. These are designed to further encourage the focus on the longer term success of the company and the consideration of arrangements for deferred remuneration including vesting and holding periods. The changes to Schedule A include an addition which states that "Remuneration incentives should be compatible with risk policies and systems".

### **Going concern**

In November 2013 the FRC proposed amendments to the Code which had the aim of:

- making a clearer distinction between the meaning of going concern in the broad context meant by Lord Sharman in his review and the narrower context used in accounting standards, by reserving the term "going concern" for the accounting purpose; and
- making a clearer link between the assessment of risks to the viability of the business (in particular, solvency and liquidity risks) and the broader risk assessment that should form part of a company's normal risk management and reporting processes, as recommended by Lord Sharman.

Specifically, the FRC had proposed deleting the provision requiring a going concern statement (existing Code Principle C.1.3) and to better link the assessment for accounting purposes with the board's broader assessment of risks to the viability of the company. This approach was broadly supported by companies but some investors argued strongly that the board's going concern statement should not be dropped and that directors should also make an explicit statement of some sort in their broader assessment of the company's ongoing viability.

The resulting compromise proposed by the FRC results in two board statements as follows:

- 1) In annual and half-yearly financial statements, the directors should continue to state whether they considered it appropriate to adopt the going concern basis of accounting in preparing them, and identify any material uncertainties to the company's ability to continue to do so over a period of at least twelve months from the date of approval of the financial statements; and
- 2) The directors should state whether, taking account of the company's current position and principal risks, they have a reasonable expectation that the company will be able to continue in operation and meet its liabilities as they fall due, drawing attention to any qualifications or assumptions as necessary. They should indicate the period covered by this statement, and why they consider that period to be appropriate.

The FRC has worked hard to develop wording which will allow boards the flexibility to provide disclosure tailored to the specific circumstances of the company. The key words to note in the second proposed statement above are “a reasonable expectation”, this is a significant change from the January 2013 consultation which was asking boards to have “a high degree of confidence”.

The consultation paper includes extracts from the integrated guidance on risk and going concern which it has amended from the original proposals to be consistent with the new statements above. In the revised guidance the following comment is made about reasonable expectation and period covered:

“Reasonable expectation does not mean certainty. It does mean that the assessment can be justified. The longer the period considered, the more the degree of certainty can be expected to reduce.

That does not mean that the period chosen should be short. Except in rare circumstances it should be significantly longer than 12 months from the approval of the financial statements. The length of the period should be determined, taking account of a number of factors, including without limitation: the board’s stewardship responsibilities; previous statements they have made, especially in raising capital; the nature of the business and its stage of development and its investment and planning periods.”

#### Deloitte comment

Our response to the November consultation paper did highlight the downside of removing the requirement for boards to include a statement that the business is “a going concern”, as it represented a useful discipline for boards to consider a paper on the topic.

We believe companies will welcome the flexibility this proposed approach allows and the lower threshold of comfort to be provided – boards should be able to produce a statement which is rooted in approved board data around the planning and investment cycles.

With increased shareholder engagement, shareholders will be able to work with companies to improve and enhance these disclosures over time so that useful information is presented. Companies will want to consider what internal assurance processes they wish to adopt before making this new statement and discuss these with their external auditors, whose duty here is to check that the directors’ statement is consistent with their knowledge and, of course, that the whole annual report is fair, balanced and understandable.

#### Principal risks and monitoring the risk management system

There was broad support for the FRC’s proposals on principal risks and monitoring the risk management system and, as such, there are no amendments to those original proposals. Subject to any comments during this consultation period, the Code will be amended to include the following provisions:

**NEW C.2.1** The directors should confirm in the annual report that they have carried out a robust assessment of the principal risks facing the company – including those that would threaten its business model, future performance, solvency or liquidity – describe those risks and explain how they are being managed or mitigated.

**AMENDED C.2.3** The board should **monitor the company’s risk management and internal control systems and**, at least annually, carry out a review of their effectiveness, and report on that review in the annual report. The **monitoring and** review should cover all material controls, including financial, operational and compliance controls. [=new text]

Some respondents to the November consultation raised concerns about the recommendation in the draft guidance that, when reporting on their review of the effectiveness of the risk management and internal control system, “the board should explain what actions have been or are being taken to remedy any significant failings or weaknesses identified from that review”. These concerns related to confidentiality and materiality. The FRC has decided to retain this recommendation in the guidance as it believes an understanding of how the company has dealt with significant control failures is of legitimate stewardship interest to its shareholders.

#### **Deloitte comment**

We believe that this is a significant part of the guidance which companies might not have focused on as much as the proposals on going concern. Early thought should be given as to how the board will wish to address the requirement to “explain what actions have been or are being taken to remedy any significant failings or weaknesses identified”.

Here also boards will want to consider what internal assurance processes they wish to adopt before making this new statement, particularly if they assert a failing or weakness has now been remedied and discuss these with their external auditors, whose duty here is to ensure the directors’ statement is consistent with their knowledge and, of course, that the whole annual report is fair, balanced and understandable. The FRC has indicated it will not issue further guidance on the matter.

#### **Audit committees and external auditors**

Following the decision of the Competition Commission (now the Competition and Markets Authority) to delay finalising its proposed Orders to implement its remedies after its review of competition in the market for audit services in FTSE 350 companies, the FRC has decided to defer consideration of whether to make any changes to the section of the Code dealing with the audit committee and appointment of the external auditor until the Code is next reviewed; currently scheduled to be undertaken in 2016.

The consultation paper also notes that the FRC intends to consult separately on guidance to audit committees on how they might report to shareholders on the findings of a review carried out by the FRC’s Audit Quality Review Team, where their company has been subject to such a review.

#### **Location and value of corporate governance disclosures**

The FRC is asking for views on whether there would be benefits from amending the Code to give companies the choice of whether to make some or all of their corporate governance disclosures available on their websites rather than in the annual report and accounts. In addition the FRC is interested in views on whether there are pieces of information required by the Code that are sufficiently important to shareholders that they should always be contained in the annual report or accounts, or which could be dropped entirely as they are of no value to shareholders.

#### **Timetable for implementation**

The FRC’s proposals on remuneration, going concern and risk would apply to reporting periods beginning on or after 1 October 2014. For a company with a December year-end this would first apply for the year ending 31 December 2015.

#### **Applicability to AIM companies and companies with a standard listing**

These changes are primarily addressed to companies subject to the UK Corporate Governance Code (i.e. companies with a premium listing of equity shares in the UK). The FRC plans to issue separate guidance on going concern for other companies.

## Deloitte view

- The changes to the remuneration section of the Code reflect the current direction of travel in the law and will ensure that the Code is keeping pace with those changes.
- The new requirement on shareholder engagement on votes against is an interesting step forward in the FRC's Effective Company Stewardship journey. This will force companies to look at voting outcomes very carefully and to respond accordingly. The proposals stop short of suggesting companies should report on the results of their actions in the following year.
- This is the FRC's third recent consultation on going concern and the proposals reflect feedback from investors about the proposed removal of the "front half" going concern statement, and the concerns from companies about the scope of the "viability statement" – this will still be challenging to draft to be meaningful, but could present a useful summary of medium term risks to a company's viability.
- We continue to support the Code amendments on risk management in the interests of good business practice and instilling confidence in UK listed companies.
- The FRC is making a sensible move to defer making any amendments to the Code in relation to audit committees and external auditors until the Competition and Market Authority's Orders have been issued. This will avoid any gaps between the different regimes arising.
- Finally, we support the cutting clutter initiative to review which disclosures can be published on the company website. We hope most companies will adopt this option when available as patchy implementation will make it harder for users who currently know where to look for governance information.

### Contacts – we value your feedback:

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If you would like further details about the Deloitte Academy, including membership enquiries, please email [enquiries@deloitteacademy.co.uk](mailto:enquiries@deloitteacademy.co.uk)

### UK Centre for Corporate Governance

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