



## Governance *in brief*

### FRC issues updated UK Corporate Governance Code and Guidance on Risk Management, Internal Control and Related Financial and Business Reporting

#### Headlines

The changes to the UK Corporate Governance Code and supporting guidance will apply for periods commencing on or after 1 October 2014:

- **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 received a significant proportion of votes opposing.
- **Going concern AND statement of longer term viability:** Going forward the annual report will include 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.
- **Risk management and internal control:** Boards will have to monitor risk management and internal control systems on an ongoing basis, rather than once a year, and will need to explain actions taken to remedy any failings or weaknesses identified. Many companies started to review their internal control monitoring systems based on the direction of travel in the consultation – the final guidance should prompt all to do so.

#### Introduction

The FRC has issued an updated version of the UK Corporate Governance Code which applies to reporting periods beginning on or after 1 October 2014. This update is the final part of the FRC’s two year review of the Code and follows earlier consultations on directors’ remuneration and risk management, internal control and the going concern basis of accounting.

As well as the updated Code itself, the FRC has also published two guidance documents:

- *Guidance on Risk Management, Internal Control and Related Financial and Business Reporting*, which revises, integrates and replaces two guidance publications *Internal Control: Revised Guidance for Directors on the Combined Code* and *Going Concern and Liquidity Risk: Guidance for Directors of UK Companies* (the “Guidance”); and
- *Guidance for Directors of Banks on Solvency and Liquidity Risk Management and the Going Concern Basis of Accounting*, which addresses supplementary considerations for the banking sector.

#### 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, main principle D.1 now states that “Executive directors’ remuneration should be designed to promote the long-term success of the company. Performance-related elements should be transparent, stretching and rigorously applied.”

The principle of avoiding more than necessary, previously in principle D.1, is retained in the supporting principles. It also makes reference to the need to be cautious about using comparisons with other companies and the risk of upward ratcheting with no corresponding improvement in corporate or individual performance.

## Extending the provisions on clawback

Clawback is strongly supported by investors and provision D.1.1 of the Code now includes:

“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 claw back or withhold remuneration it will be a requirement to explain why this is the case.

## 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 has not taken this proposal any further.

## Conflicts of interest

The supporting principle in D.2: Procedure has been updated 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

A number of changes have been made 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 considering the appropriate length of 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”.

### Deloitte comment

The most significant change is that relating to clawback. Previously clawback was mentioned only in Schedule A of the Code, requiring companies to have given consideration to the use of provisions that would permit the reclaiming of variable components in exceptional circumstances of misstatement or misconduct. The wording of the updated Code is a little ambiguous in that it could be taken to imply that companies should have the ability to be able to reclaim AND withhold payments or alternatively that having the ability to either reclaim OR withhold may constitute compliance. However, we have clarified with the FRC that the intention is that companies should have the ability to do both and remuneration committees will therefore need to focus on the implication of these changes. This will include what practical steps may need to be taken, what documentation may be required, the extent to which this may constitute a change to current policy and the implications for disclosure.

## Shareholder engagement

### Votes against AGM resolutions

The 2012 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.

Provision E.2.2 which deals with the constructive use of the AGM, covering all resolutions, not just those relating to remuneration. When announcing the results of an AGM vote, companies should set out how they intend to engage with shareholders to assess their concerns which have led to a significant vote against a resolution, rather than how they intend to address these concerns. Clearly, companies are likely to want to communicate the results of that engagement and any changes they are making, but this is not a requirement of the Code. The Code does not define what constitutes a ‘significant proportion’ and this will be left to each company to assess.

### Deloitte comment

The announcement of voting outcomes is usually made soon after the conclusion of the general meeting and companies will therefore need to consider adjust their current process to discuss the voting pattern at the board meeting that often immediately follows the AGM if there are situations where there is a significant vote against a resolution.

### Going concern

The intention behind the FRC's changes in this area has always been to:

- make 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
- make 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.

The changes to the Code follow the proposals in the consultation paper issued in April 2014 and going forward boards will need to provide two statements:

- 1) The Going Concern Statement: In annual and half-yearly financial statements, the directors should state whether they considered it appropriate to adopt the going concern basis of accounting, and identify any related material uncertainties looking forward over a period of at least twelve months from the date of approval of the financial statements (Code Provision C.1.3); and
- 2) The Longer Term Viability Statement: 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 over the period of their assessment, drawing attention to any qualifications or assumptions as necessary (Code Provision C.2.2).

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. In the *Guidance on Risk Management, Internal Control and Related Financial and Business Reporting* the following comment is made about reasonable expectation and period covered for the new viability statement required by provision C.2.2:

"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."

In relation to the qualifications or assumptions referred to in the board statement, the Guidance states:

"Any qualifications or assumptions to which the directors consider it necessary to draw attention in their statement should be specific to the company's circumstances, rather than so generic that they could apply to any predictions about the future. They should be relevant to an understanding of the directors' rationale for making the statement. They should only include matters that are significant to the company's prospects and should not include matters that are highly unlikely either to arise or to have a significant impact on the company. Where relevant, they should cross-refer to, rather than repeat, disclosures given elsewhere".

The Guidance also makes the point that there may be a degree of overlap both with the disclosures on principal risks and with disclosures over any material uncertainties relating to the going concern basis of accounting, and that companies should consider how best to link these disclosures.

### Deloitte comment

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 and have likely made similar forward looking public statements in capital raising documents.

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 analytical and 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 has continued to be broad support for the FRC's proposals on principal risks and monitoring the risk management system and, as such, there are no amendments to the April 2014 proposals. The Code has been 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. The directors should 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]

There had been concerns raised 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 but has included the following guidance on the reporting of these failing or weaknesses:

"Where this information [reporting on failings or weaknesses] has been disclosed elsewhere in the annual report and accounts, for example in the audit committee report, a cross-reference to where that information can be found would suffice. In reporting on these actions, the board would not be expected to disclose information which, in its opinion, would be prejudicial to its (the company's) interests."

### Deloitte comment

For the majority of businesses, especially those in less regulated industries, we believe that the adoption of these changes will represent a significant challenge. For example, is there sufficient effort on managing and monitoring principal risks on a continuous basis and how well are the constituent parts of the governance framework (e.g. management information, technology, assurance) linked together?

Early thought should be given as to how the board will wish to address the recommendation to "explain what actions have been or are being taken to remedy any significant failings or weaknesses".

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 that the whole annual report is fair, balanced and understandable.

## **The new Guidance on Risk Management, Internal Control and Related Financial and Business Reporting**

The new guidance, issued concurrently with the Code, has been developed with the aim of bringing together elements of best practice for risk management. It seeks to:

- prompt boards to consider how to discharge their responsibilities in relation to the existing and emerging principal risks faced by the company;
- reflect sound business practice whereby risk management and internal control are embedded in the business process by which a company pursues its objectives; and
- highlight related reporting responsibilities.

We recommend that all board members should take the time to read the guidance – it is a very manageable 25 pages – but have drawn out here certain paragraphs that are particularly helpful:

**Definition of principal risk** – a principal risk is a risk or combination of risks that can seriously affect the performance, future prospects or reputation of the entity. These should include those risks that would threaten its business model, future performance, solvency or liquidity (footnote to page 1).

**Board responsibilities for risk management and internal control** – the board’s responsibilities (para 24):

- ensuring the design and implementation of appropriate risk management and internal control systems that identify the risks facing the company and enable the board to make a robust assessment of the principal risks;
- determining the nature and extent of the principal risks faced and those risks which the organisation is willing to take in achieving its strategic objectives, i.e. determining its “risk appetite”;
- ensuring that appropriate culture and reward systems have been embedded throughout the organisation;
- agreeing how the principal risks should be managed or mitigated to reduce the likelihood of their incidence or their impact;
- monitoring and reviewing the risk management and internal control systems, and the management’s process of monitoring and reviewing, and satisfying itself that they are functioning effectively and that corrective action is being taken where necessary; and
- ensuring sound internal and external information and communication processes and taking responsibility for external communication on risk management and internal control.

**The annual review of effectiveness** – this should, in particular, consider (para 43):

- the company’s risk appetite, the culture within the company and whether that culture has been embedded;
- the operation of the risk management and internal control systems;
- the integration of risk management and internal controls with considerations of strategy and business model, and with business planning processes;
- the changes in the nature, likelihood and impact of principal risks, and the company’s ability to respond to changes in its business and the external environment;
- the extent, frequency and quality of the communication of the results of management’s monitoring to the board and the effectiveness with which risk is being managed or mitigated;
- issues dealt with in reports reviewed by the board during the year; and
- the effectiveness of the company’s public reporting processes.

**Safe harbour provision for reporting** – when reporting under the new provisions, the board should remember the safe harbour provision which exists under section 463 of the Companies Act 2006 which limits the directors liability for any untrue or misleading statement to just the company as long as the statement is made in the Strategic Report, the Directors’ Remuneration Report or the Directors’ Report (para 62).

**The basis for the longer term viability statement** – the statement should be based on a robust assessment of those risks that would threaten the business model, future performance, solvency or liquidity of the company, including its resilience to the threats to its viability posed by those risks in severe but plausible scenarios. Such an assessment should include sufficient qualitative and quantitative analysis, and be as thorough as is judged necessary to make a soundly based statement. Stress and sensitivity analysis will often assist the directors in making their statement (Appendix B para 4).

**Questions for boards to consider** – Appendix C of the guidance sets out some suggested questions which boards may wish to consider and discuss with management and others.

### **Some interesting amendments to the Preface to the Code**

As part of the exercise to issue the updated Code, the Preface to the Code has been updated and includes some further recommendations for boards. Whilst not forming part of the “Comply or explain” provisions of the Code or representing a new principle, the comments provide a clear indication of the FRC’s views on these matters and the significance they place on them.

#### ***Diversity and board dialogue***

The Preface identifies that problems arising from “groupthink” were exposed as a result of the financial crisis and that one of the ways in which constructive debate can be encouraged is through having sufficient diversity on the board. The Preface states “Diversity is as much about differences of approach and experience, and it is very important to ensure effective engagement with key stakeholders in order to deliver the business strategy”.

#### ***Board culture***

A clear statement has been included in relation to the importance of the board setting the correct ‘tone from the top’. The Preface states “The directors should lead by example and ensure that good standards of behavior permeate throughout all levels of the organisation. This will help prevent misconduct, unethical practices and support the delivery of long-term success”.

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

In April the FRC had asked 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 was 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.

The feedback statement which has been issued with the updated Code notes that there was some support amongst issuers and audit firms to moving corporate governance disclosures online. However, a significant number of investors and their representative bodies argued that removing such disclosures could be harmful. The FRC will continue to keep this under review as part of the Financial Reporting Lab’s long-term project looking at the use of digital media by companies to report externally to investors.

### **Timetable for implementation**

The FRC’s updated Code applies 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) and so do not apply to AIM companies or companies with a standard listing. However, it is important to remember that all UK incorporated companies that are not small are required to prepare a strategic report which must include a description of the principal risks and uncertainties facing the company so elements of the new guidance may be helpful for all companies, including private companies required to meet that requirement.

In addition, the Disclosure and Transparency Rules (DTR 7.2.5R) state that companies whose securities are admitted to trading on a regulated market (which includes both premium and standard listings) are required to include a description of the main features of the company's internal control and risk management systems in relation to the financial reporting process.

#### Deloitte view

- **Remuneration:** We welcome the change to the main principle on remuneration which puts the key focus on designing remuneration to promote the long term success of the company and ensuring that variable remuneration is transparent and tied to stretching and rigorous performance targets. We also believe the change to provision D. 2 will be helpful in encouraging the remuneration committee to be aware of the potential conflicts of interests when considering the views of the CEO and other executive directors.
- **AGM Voting:** The new requirement on shareholder engagement on voting 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, but we expect many will wish to do so.
- **The new viability statement:** This will be challenging to draft in a meaningful way, but done well will become a very helpful qualitative and quantitative summary of medium term risks to a company's viability.
- **Risk Management:** We continue to support the Code amendments on risk management in the interests of good business practice and enhancing confidence. The new guidance will present quite a challenge for some companies and we recommend that directors take the time to read this carefully.

### Auditing changes

Just as changes were introduced for auditors requiring them to report by exception on the directors' fair balanced and understandable statement, changes are also being made requiring auditors to comment on the viability statement and the package on principal risk disclosures which are reflected in revised versions of ISA 260 *Communication with those charged with governance*, ISA 570 *Going concern* and ISA 700 *The independent auditor's report on financial statements*.

Auditors will now have a responsibility to state in their report whether they have *anything material to add or draw attention to* in relation to the directors' confirmation in the annual report of their assessment of principal risks together with related disclosures of those risks and how they are being managed or mitigated, the disclosures in the financial statements about the going concern basis of accounting and the "viability statement" about the directors' reasonable expectation that the entity will continue in operation and meet its liabilities as it falls due over the period of their assessment.

#### Deloitte view

- We expect companies and auditors to engage extensively on the wording of the description of principal risks and the longer term viability statement. Early discussion around the appropriateness of the period used for the viability statement, the extent of disclosures around principal risks and mitigation will make this discussion more effective.
- Auditors will ask the board for a paper to support their judgements on both the going concern basis of accounting and the viability statement. Boards will want to consider whether an appropriate process is in place to produce such a paper, drawing distinctions between the two assessments whilst checking that there is no inconsistency between the assumptions underpinning each.

### Further information

To access the updated Code and supporting guidance documents please go to <https://www.frc.org.uk/News-and-Events/FRC-Press/Press/2014/September/FRC-updates-UK-Corporate-Governance-Code.aspx>.

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### UK Centre for Corporate Governance

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Designed and produced by The Creative Studio at Deloitte, London. 38283A