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Governance *in brief*
2015 – a focus on culture and enhanced explanations

Headlines

- Boards have responsibility for shaping the culture of their companies, both within the boardroom and across the organisation as a whole – and this requires constant vigilance.
- The FRC has no desire for the Code to be viewed as a rulebook and will be re-emphasising the value of 'comply or explain' in achieving good governance.
- The results of the FRC's review of non-compliances have been mixed, with some companies seemingly unwilling to address the spirit and practice of good quality explanations.

Introduction

The FRC's latest corporate governance and stewardship monitoring report observes that there has been an increase in compliance with the UK Corporate Governance Code. In addition, the FRC believes that reporting has become more transparent and informative. On stewardship the report notes that 2014 has seen an increase in signatories to the Stewardship Code with signs of better engagement by investment managers at least with the very largest companies. However, more needs to be done to ensure asset owners and managers follow through on their commitment to the principles set out in the Code.

The FRC has set out a number of key issues for consideration by companies and investors in 2015. These include:

Company culture

The FRC paper confirms the importance of good corporate culture and embedding sound governance behaviours throughout the company. During 2015 the FRC will review how best to assess culture and practices and embed good corporate behaviour throughout companies and will consider whether there is a need for promoting best practice. The recent guidance on risk management highlighted the need for boards to think hard about assessing whether the culture practised within the company is actually in line with what boards espouse. In particular, the FRC believes boards should consider the following:

- what assurance does a board receive around culture?
- are performance drivers and values consistent?
- how can culture be maintained under pressure and through change?
- do the leaders role model the values and culture of the business?

Board composition and succession planning

The FRC's project on succession planning is aimed at identifying and promulgating good practice and, more specifically, at how the nomination committee can play its role effectively. In this report the FRC states that unless boards are planning over the medium to long-term, for both executive and non-executive positions, they will struggle to ensure that there is the right mix of skills and experience needed as the company evolves. Research from Cranfield has shown that many companies still only talk about succession planning in terms of replacing individual board directors – in other words, usually a short term tactical response that does not address the more strategic issue of longer term, forward-looking, succession planning.

The FRC intends to publish a discussion paper in the Spring which will include preliminary findings and a request for views.

Active engagement between boards and investors

Whilst there has been evidence of more engagement on a wider range of issues taking place between larger companies and major investors, the FRC is not confident that this is taking place across the listed sector with sufficient quality. The FRC is concerned that too many signatories to the Stewardship Code do not do what they have committed to do. It is hoped that the activities of the Investor Forum in this area will help to create an effective model for collective engagement with UK companies.

During the first half of 2015, the FRC will begin a project to study how best to promote a culture of stewardship and its benefits and how to increase scrutiny of adherence to the Code in order to improve the quality of practice and reporting. In particular, the FRC is aware of mixed reports about the quality of reporting, engagement and voting outcomes coming from the relationship between some proxy advisors and their clients.

Early consideration of the new viability statement

The 2014 UK Corporate Governance Code introduces a new provision which calls for boards to state whether they believe they will be able to continue in operation and meet their liabilities taking account of their current position and principal risks; boards have to specify the period covered by this statement and why they consider it appropriate. The new provision applies for periods commencing on or after 1 October 2014 and the FRC is recommending early consideration of the new statement by boards so that they are in a position to provide meaningful disclosures come the 2015 reporting season.

Maintaining effective risk management and internal control systems

The 2014 Code also introduces a provision which states that boards should monitor their risk management and internal control systems and, at least annually, carry out a review of their effectiveness, and to report on that review in the annual report. The FRC is emphasising that this new provision may require new activity during the year to maintain, and monitor, effective risk management and internal control systems. Some companies will require more work than others so it is best that necessary actions are identified sooner rather than later, particularly if they intend to follow the best practice guidance set out in the FRC's Guidance on Risk Management, Internal Control and Related Financial and Business Reporting. Our 'Governance *in brief*: Are you at the risk for your new year?' set out a number of key mobilisation steps to help in this regard.

Focussing on the quality of explanations

The FRC notes that companies often seem to find it easier to explain what their actual governance arrangements are and, where relevant, the actions intended to make the company compliant with the Code, rather than to explain why they consider current arrangements to be the most appropriate for the company. The FRC is keen to remind companies and investors that simply complying with the Code without giving due consideration to what is appropriate and relevant reduces the flexibility that the 'comply or explain' approach aims to achieve. The FRC will communicate further on this in the first half of 2015.

Deloitte View

- We agree that a strong culture is fundamental to both the success of a company and good governance. From our work in this area, we observe that the challenge is often in leadership, translating values into culture and action and embedding culture through a multi-layered organisation on a sustained basis. Best practice guidance developed by the FRC should focus on how companies can most effectively promulgate strong culture and values and develop the supporting feedback and reward systems.

- The 'comply or explain' basis enables the UK to introduce corporate governance enhancements that take time to implement and we are pleased to see this very open acknowledgement in light of the significant changes introduced in respect of risk and internal controls in the second half of 2014. The freedom to give company specific explanations for non compliances enable a more tailored and transparent portrayal of stewardship and governance at individual companies. We hope that governance reporting agencies who make voting recommendations will respect reasoned explanations.

For further information

The full report can be accessed from www.frc.org.uk.

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