Corporate governance update

News worth knowing

EY’s Corporate Governance Team is pleased to introduce Issue no. 8 of this newsletter. We hope you find it interesting and informative. It gives you the latest highlights on the issues that matter, prioritises issues likely to have a more immediate impact, and shows you where you can find out more. We would of course be glad to hear from you about these or any other topics. You can find our contact details on the back page.

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No-holds barred in fight against corruption

In December 2014 the UK Government published its long awaited cross-government UK Anti-Corruption Plan (“the Plan”), to be implemented by the end of 2015. The aim of the Plan is twofold: to demonstrate the breadth of the UK’s anti-corruption activities, and to set out what actions the Government will take (including changes to UK law) to tackle corruption in the UK.

At the heart of the Plan are 66 action points. Most, but not all, are new and wide-ranging in scope. Some are specific and localised, such as extending the National Offenders Management Service. Others are more complex and seek to drive fundamental changes in UK law.

The wide-ranging scope of action points is indicated by the large number of government departments (ten) and agencies (six) involved with the implementation of the Plan.

Three aspects of the Plan which are particularly noteworthy, because of the potential implications for corporate governance and risk management, are highlighted below:

- The establishment by the National Crime Agency of a national multi-agency intelligence team focusing on serious domestic and international corruption. Closely related to this is the proposed development of a single reporting mechanism for allegations of corruption.
- The introduction of new measures to incentivise and support whistle blowers in cases of corruption, and to evaluate recent changes in the law on whistle blower provisions, including the use of financial incentives.
- The examination of proposals for a new offence of corporate failure to prevent economic crime and wider corporate criminal liability. The idea is to extend Section 7, Corporate Offences, UK Bribery Act (the failure to prevent bribery by associated persons) to cover fraud and economic crime more generally.

The Plan states that ‘there are likely to be other forms of economic crime for which it is appropriate to ensure that senior corporate actors are sufficiently accountable’.

Our viewpoint

- We welcome this plan because the effective enforcement of the law, as a stimulus to business to take anti-fraud and anti-bribery measures seriously, requires suitably qualified resources.
- We are particularly pleased about the proposed development of a single reporting mechanism for allegations of corruption. This is because information sharing across different agencies is, in our view, crucial for effective law enforcement in this area.
- While the Plan is entitled UK Anti-Corruption Plan, several of the action points could impact counter-fraud measures and compliance obligations (and in particular anti-money laundering) more generally. So companies will need to follow the implementation of the Plan very closely and prepare accordingly.

UK Anti-Corruption Plan

Closer bonds across capital markets

In February 2015 the European Commission (“EC”) launched a green paper, The Capital Markets Union (“CMU”). The paper outlines ways to open the European market for non-bank funding across all 28 member states. This is in response to difficulties faced by companies, large and small, when seeking to raise finance.

The CMU aims to support the EC’s long-term investment plan by removing barriers to cross-border investments in the EU, and in the process diversify the way EU economies and businesses are funded. It is hoped this will simplify and reduce the cost of raising capital, especially for smaller companies.

EU Commissioner Jonathan Hill, responsible for Financial Stability, Financial Services and Capital Markets Union, stated on the EC’s
website: ‘CMU is about unlocking liquidity that is abundant, but currently frozen, and putting it to work in support of Europe's businesses, particularly SMEs.’

- The Green Paper identifies various key principles and tasks it regards as necessary precursors for the successful launch of CMU. These include, but are not limited to:
  - The establishment of EU-wide financial stability with a single rulebook for financial services, effectively and consistently enforced to provide investor protection; and
  - The implementation of European Long-Term Investment Funds (ELTIF) regulation, high-quality securitisation procedures, standardised credit information on SMEs, and a review of the Prospectus Directive to see if some of these requirements can be modified or removed for smaller companies.

- The EC’s current plan is to use feedback from the consultation to develop an action plan in the summer of 2015. Key elements of this plan will be a roadmap and timeline for introducing CMU by 2019.

**Our viewpoint**

- Lord Hill's recommendations for CMU could hold the key to building a sustained economic recovery in Europe. We agree that the EU's significant dependence on banks to transmit funding into the market needs to be supplemented with other sources.

- The Green Paper, with its focus on ELTIFs, securitisation, private placement, and IPOs, and a clear acknowledgement that banks still need to play a vital role in the economy, is a sensible and pragmatic step in the right direction.

- An important reason for the EU market remaining shallow and fragmented is the difference in regulatory, tax and fiscal regimes across the bloc. We are pleased that Lord Hill's paper indicates that the EC is going to work with the markets to try to solve some of these issues rather than looking to add more layers of regulation. This will take some time but should deliver a better solution in the long-term.

**EU Capital Markets Union**

**Women on boards – on track to meet 25% target**

On 25 March 2015 the Department for Business Innovation and Skills published *Women on Boards Davies Review Annual Report 2015* (“the Report”). In his foreword to the Report, Lord Davies says he is ‘confident that we will meet the 25% in the coming months, and with continued action and focus, this paradigm shift will be sustained in the long term.’

- On FTSE 100 boards, women's representation now stands at 23.5% (up from 12.5% in 2011) and fewer than 20 new women appointments are needed to meet the target of 25% representation of women on FTSE 100 boards by the end of 2015. A total of 41 FTSE 100 boards already have a representation of 25% or better (up from 12 in 2011).

- However, Lord Davies also stated: ‘Boards are getting fixed, now we have to fix the low number of women chairs and executive directors on boards and the loss of talented, senior women from the executive pipeline.’ A lower appointment rate of women to FTSE 250 boards also signals "a need for continued focus on FTSE 250 progress."

- The Report highlights, amongst other things, that:
  - While there are now no all-male boards in the FTSE 100 (down from 21 in 2011), 25 FTSE 100 boards have a representation of women below 20% and 12 FTSE 100 companies have only one woman on their boards.

- Representation of women on FTSE 250 boards now stands at 18% (up from 7.8% in 2011) and 23 all-male boards remain in the FTSE 250 (down from 131 in 2011).

- Appointment rate of 23.9% of women to FTSE 250 boards is lower than anticipated.
this year, and too few women are still being selected as exec directors, chairs, CEOs and senior independent directors. For example:

- Amongst FTSE 100 companies (compared with 2011 figures) women now represent: 8.6% (up from 5.5%) of exec directors; 28.5% (up from 15.6%) of non-exec directors; 3 (up from 2) chairs; and 5 (no change from 2011) CEOs.

- The situation is no better amongst the FTSE 250, compared over the same period. For example, women now represent: 4.6% (up from 4.2%) of exec directors; 23% (up from 9.6%) of non-exec directors; 8 (up from 0) chairs; and 9 (down from 10) CEOs.

- In respect of action to be taken, the Report, amongst other things, encourages:
  - Companies to take action now to improve the gender diversity on their boards, especially those with just one woman on their boards.
  - Chairmen, presiding over all-male boards, to recruit women to their top team, irrespective of their company size or sector.
  - Nomination committees to improve their reporting.

Our viewpoint

- There is a large and growing body of research, including a new survey we commissioned, which proves that accelerating women's advancement in the workplace and creating gender-balanced teams, boards and governments produces a greater diversity of thought, better outcomes and prosperity.

- Independent research has also found that companies with more women in leadership increase focus on corporate governance, corporate responsibility and talent dynamics.

- Boards should ensure that improving gender balance does not distract them from the broader need for greater diversity and the value this can bring.

**EY The time for gender parity is now (2015)**

**Women on boards 2015 review**

**The female FTSE board report 2015 (Cranfield University)**

**FRC planning for long-term gain**

In March 2015 the Financial Reporting Council (FRC) published its Plan & Budget for 2015/16. This is the final year of the FRC's three-year strategy designed to promote high quality corporate governance and investor stewardship in the UK. The strategy is specifically geared towards good governance, and in particular high quality reporting and auditing with effective regulatory oversight. Examples of some of the FRC's planned initiatives are highlighted below.

Corporate governance

- The FRC is planning to assess the quality of board succession planning and how it can promote best practice in this area of governance. Related to this is the assessment of corporate culture and how boards can shape this to embed good corporate behaviour.

- In the context of risk the FRC is also planning to review the adoption of new risk management and viability reporting, introduced in last year's revised UK Corporate Governance Code (See NWK Issue 7).

Investor stewardship

- The FRC has expressed concern over the effectiveness of the UK Stewardship Code (“the Code”). It acknowledges that the Code is still relatively new, but this year it plans to seek out evidence of its use and encourage asset
managers and owners to provide better disclosures on their engagement policies and practices.

- The FRC plans to scrutinise the signatories to the Code to get a better understanding of how, and to what extent, these institutions follow the principles and apply the provisions of the Code. Whilst undertaking this work the FRC also wants to play an active role in the UK’s implementation of the EU’s Shareholder Rights Directive, due to take effect towards the end of 2015.

Corporate reporting

- This year the FRC’s review panel intends to look closely at approximately 250 corporate reports from companies in the following sectors: insurance, food and drink, consumer goods manufacturers, retailers, extractive and business services sectors. They will be interested in the reporting of revenue recognition, complex supplier arrangements, business combinations and the implementation of new accounting standards.

- Alongside this activity the FRC will also be evaluating the impact of its Guidance on the Strategic Report, as well as continuing with its ongoing project to improve the quality of reporting by smaller and AIM listed companies. It will also be working closely with the UK Government on the implementation of the Non-financial Reporting Directive.

Audit quality reviews

- In 2014 the Competition & Markets Authority (CMA) issued its Order for the UK audit market (see NWK Issue 7). This was followed with a recommendation that the FRC inspect the audits of every constituent of the FTSE 350, at least once every five years. The FRC has indicated its intention to do this, and in 2015 its inspection team aims to review 140 audit engagements.

- This will include a focus on first-year audits and audit sampling. The FRC is also going to assess how audit committees are applying, on a voluntary basis, the CMA’s recommendations on disclosing audit quality reviews on their respective statutory audits.

Actuarial

The FRC plans to finalise the actuarial standards framework, and in the process take account of the risks to the public interest for which actuarial work is relevant. It will consult on revisions to the four Technical Actuarial Standards on insurance, pensions, funeral plans and transformations.

Our viewpoint

- We support the FRC’s future work on succession planning and the nomination committee. Directors tell us that these aspects of governance are particularly challenging, so we support initiatives that encourage them to take a lead in sharing best practice in these areas. Indeed, we have published a report together with the Investment Association, to highlight leading practice in board effectiveness.

- Another area of note is narrative reporting, and in particular the need to provide more support and encouragement to smaller companies. In this regard we support the work of the Financial Reporting Lab to promote leading practice reporting.

- Finally, we welcome further initiatives by the FRC to promote shareholder engagement. We too are committed to engaging with shareholders and have initiated our own programme to facilitate a constructive investor dialogue.

FRC Plan & Budget 2015/16

Board effectiveness – continuing the journey

Reporting

Government reviews remuneration

On 6 March 2015 the UK Government published a research report: How companies and shareholders have responded to new requirements on the reporting and governance of directors’ remuneration. It assesses the effectiveness of the
Large and Medium-Sized Companies and Groups (Accounts and reports) (Amendment) Regulations 2013 (“the Regulations”), with recommendations for follow up actions.

The research shows that most companies complied with the regulations, although some issues were identified in two particular aspects of the regulations, as identified below.

Maximum future salary

► There is a significant level of non-compliance with the requirement to specify, in monetary terms or otherwise, the maximum future salary that may be paid under the remuneration policy.

► The Government attributes this to unclear guidance which may have caused confusion. It refers to two clauses, one that requires companies to: ‘describe the considerations the remuneration committee will take into account for increasing salaries’ and the other which says that ‘the maximum salary must be explained’.

► The Government claims many companies may have mistakenly thought a ‘description of what the remuneration committee takes into consideration’ a sufficient disclosure on maximum future salary, when what is required is an actual figure together with an explanation. To fix this the Government is seeking to clarify its guidance on the matter.

Consideration of workforce pay and shareholders’ views

► Many companies provided insufficient detail for shareholders on how the board and its remuneration committee take workforce pay into consideration, when formulating remuneration policy for executives. That said, the Government is pleased to note that approximately half of the companies sampled are showing the emergence of detailed disclosures in this aspect of the remuneration report.

Overall outlook

► In conclusion, the Government notes that increases in total pay has ‘radically slowed’, especially in the past two years, and the slowdown is happening ‘more aggressively at larger companies than smaller ones’. It adds that remuneration resolutions are on average three times more contentious than other types of resolutions, with higher levels of dissent for binding votes on policies, than for advisory votes on reports.

Our viewpoint

► We conducted our own review of remuneration reports in 2014 and found a varied interpretation of the regulations, with some companies focused on complying and others on improving their depth of disclosure. Examples of our findings are listed below.

► There were divergent views on the level of detail necessary, with many companies limiting their narrative in key areas, and over-disclosing in areas not typically considered sensitive.

► Introductions from remuneration committee chairs (i.e., in the annual statements) lacked impact and were not fully leveraged as communication tools, especially with time restricted investors.

► There was a marked increase in the level and depth of retrospective disclosure of performance against targets for the annual bonus, but only a third of companies comprehensively reviewed their remuneration policy during the year. This may suggest that the focus was more on articulating compliance rather than reviewing remuneration strategies and the robustness of the link between pay with performance.
Lifting the corporate veil - Transparency Directive changes UK regime


Some provisions in the TDAD (i.e. the requirement to report on payments to government and removal of the requirement to publish interim management statements) came into effect for financial years beginning on or after 1 January 2015 and have already been implemented in the UK by the Financial Conduct Authority (FCA).

HM Treasury and the FCA are now consulting jointly - in CP15/11: Implementation of the Transparency Directive Amending Directive (2013/50/EU) and other Disclosure Rule and Transparency Rule Changes - on the implementation of the other provisions in the UK. In broad terms, CP15/11 proposes amendments to the Financial Services and Markets Act (FSMA) and the Disclosure and Transparency Rules (“DTR”). For example, the latter includes:

- A requirement to disclose voting rights arising from holdings of financial instruments that have a similar economic effect to holding shares.

- An extension of the deadline to publish half-yearly reports (from two months to three) and the period of time for which financial reports are publicly available.

The FCA is also consulting on other miscellaneous amendments to the DTRs to improve the UK domestic regime, including changes to the:

- Current treatment of stock lending and borrowing in DTR5.1.1R(5) and DTR5.1.3R(6).

- The treatment of investment managers under DTR5.1.5R.

- The current drafting of DTR5.11.6R: and the equivalence provisions for third country issuers (non-EEA issuers).

The consultation closes on 20 May 2015.

Our viewpoint

- The approach to requirements for reporting on payments to governments is creating concern for those companies affected by it. It is seen by many as complex, burdensome and still not necessarily the panacea to improve transparency.

- As with other EU Directives, it is hoped that the provisions of the TDAD will be implemented consistently by different member states. This should help to reduce complexity for companies operating in different European jurisdictions.

- However, time will tell whether all of the changes will benefit all of the stakeholders. For example, allowing interim reports to be published in three months instead of two may benefit companies, but this could result in less timely information reaching investors.

EU Transparency Directive

Financial Conduct Authority: CP15/11 and CP 11/125

Auditing

UK grapples with EU audit reform implementation

On 15 December 2014 the UK Government’s Department for Business Innovation & Skills (BIS) and Financial Reporting Council (FRC) published, respectively, a discussion paper and a consultation paper on the implementation of the EU’s audit reform legislation. This comprises of a regulation and directive which came into force on 16 June 2014 and will apply in member states from 17 June 2016. Both papers closed for responses in March
2015 and detailed consultations will follow, from both BIS and the FRC, later this year.

- The BIS discussion paper sought views on, amongst other things: a proposed framework for mandatory retendering and rotation; whether the FRC should be the single competent authority with ultimate responsibility for audit regulation (delegating tasks to the Professional Supervisory Bodies); and, which member state options should be taken up in the UK.

- The provisions in the EU legislation impact on auditing and ethical standards, which fall within the purview of the FRC. Accordingly, the FRC's consultation paper outlined which options it is inclined to take, on the assumption that it will have the authority to make these choices. The FRC also consulted on how to apply the cap and prohibitions on the provision of non-audit services (NAS) to Public Interest Entities (PIEs).

Some of the key proposals on UK implementation can be summarised as follows:

**Definition of a PIE**

- BIS did not propose widening the EU’s definition of a PIE for statutory purposes. The FRC agreed with this position, but as its definition of a listed entity (to which it applies its auditing and ethical standards) is broader than the EU’s definition of a PIE, the FRC consulted on applying some of the more stringent EU requirements, such as the NAS restrictions, to this wider population.

**Audit tenures**

- BIS proposed extending the “maximum” ten-year audit tenure by a further ten years, subject to a “qualifying” competitive tender in year ten. The FRC wanted to know whether the finally agreed tenure period should be enshrined in its audit and/or ethical standards - with the effect that auditors have responsibility for ensuring they do not act as auditor when they are effectively barred by law from doing so.

- Another point of consideration was whether more flexibility could be added to the year of tender, so companies can conduct a “qualifying” tender earlier on, before the tenth year of tenure has been reached.

- The FRC also considered whether it should retain its current limit on audit partner engagement of five years, or extend partner engagement to a maximum of seven years, as per the regulation (although it was inclined to retain the five year limit).

**NAS**

- The FRC consulted on whether to extend the prohibited NAS in its Ethical Standards to comply with the new Regulation, or whether to introduce an allowed list of NAS. It also consulted on whether to extend the NAS prohibitions to group companies outside the EU and whether to apply the cap on NAS fees to NAS provided by any part of a firm’s network (not just the firm conducting the statutory audit).

- The FRC did not, however, propose increasing the 70% cap on NAS fees as it may limit the ability of companies to obtain permissible NAS. It also proposed allowing exemptions from the cap for a period no greater than two years, for companies in circumstances where the cap might limit certain NASs which could harm the interests of the company and its shareholders.

**Our viewpoint**

- When considering how best to implement the EU legislation, we encourage the Government and FRC to follow the Government’s general guidance not to “gold plate” EU legislation (e.g., no extension of the PIE definition, and no extension of NAS restrictions beyond EU PIEs).

- PIEs should be allowed to choose when to tender within overriding principles; namely that a PIE cannot: i) go longer than 10 years without a tender; and ii) keep the same audit firm for more than 20 years. No more prescription is necessary on this.

- Our preference is for a list of prohibited NAS services. A permitted list could work if it included principles/hallmarks of a permitted
service (if not specifically listed). In this regard audit committees should be empowered, so far as is permissible under EU and UK legislation, to exercise balanced judgment on behalf of shareholders.

 Exceptions from the cap on NAS are needed and the method of calculation and application of the cap in EU Regulation should not be different in the UK. Also, improvements could be made to the transparency of NAS fee disclosures, to make them more useful for users.

Questions worth asking

Are the company’s internal controls and risk management processes fully attuned to upcoming legal requirements for UK companies to prevent economic crime?

Is the board and management team satisfied that key personnel in other parts of the company, both in the UK and overseas, are fully aware of their obligations towards the prevention of economic crime?

If the company is planning to seek non-bank financing in the near future, has the board familiarised itself with EU developments to improve access to this form of financing?

Is the board satisfied that its nomination committee, and succession plans, take full account of growing expectations for better balanced boards?

Has the company engaged with its search and recruitment advisers, to address the need for gender balance and diversity on its board and board committees?

Has the remuneration committee taken into account the Governments’ findings and recommendations from its recent review of remuneration policy and reporting?

Are members of the audit committee in agreement on what steps need to be taken to appoint a new auditor, in compliance with EU regulations and the CMA Order on competitive tenders?

Is the board in agreement as to which firms it would prefer to use for non-audit services, and which ones it would like to consider as the next statutory auditor?

BIS: Discussion document on the implications of the EU and wider reforms

FRC: Consultation on the implementation of the EU Audit Directive and Audit regulation
Examples of other developments and information sources worth noting

EY publishes a thought leadership paper and results of a poll: *The viability statement – finding opportunities in the new regulatory challenge.*  
[LINK]

EY and the Investment Association publish a report: *Board effectiveness – continuing the journey.*  
[LINK]

FRC publishes its review of UK corporate governance in 2014, covering compliance with the UK Corporate Governance Code.  
[LINK]

FRC reviews external auditors’ mandatory transparency reporting. This is a review of the first year’s implementation.  
[LINK]

FRC publishes the findings of its review of extended auditors’ reports (covering the first year of implementation).  
[LINK]

ICSA launches a new report for company secretaries on how to build trust through corporate governance.  
[LINK]

IOD publishes a report which considers future developments in corporate governance in the UK.  
[LINK]

UK Government issues a report on a joint initiative with the insurance sector to manage and mitigate cyber security risks.  
[LINK]

BIS issues the Burt report on inclusive support for women in enterprise, written by Lorely Burt MP, Government Ambassador for Women in Enterprise.  
[LINK]

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