Corporate governance update

News worth knowing

EY’s Corporate Governance Team is pleased to introduce Issue no. 7 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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Building a better working world
Board matters
Biennial growth in governance code

On 17 September 2014 the FRC published a revised version of the UK Corporate Governance Code (“the Code”). Changes take effect for financial years beginning on or after 1 October 2014.

- Changes resulting from this latest biennial review fall into three categories: risk management, internal control and going concern, executive remuneration and relations with shareholders.

- The intention of the FRC in making the changes is, amongst other things, ‘to strengthen the focus of companies and investors on the longer term and the sustainability of value wealth creation’.

- The FRC has also taken the opportunity, in a refreshed preface to the Code, to emphasise the importance of:
  - The board’s role in establishing the correct ‘tone from the top’ and culture, values and ethics of the company.
  - A constructive and challenging dialogue - essential to the effective functioning of the board - which can be encouraged through, amongst other things, having sufficient board diversity (including, but not limited to, gender and race).

- The following three articles explore some of the key changes under each of the three categories.

Closure on going concern debate

We have chartered the progress of Lord Sharman’s recommendations on going concern and liquidity risks in these updates. The outcome in 2014 is a combination of changes to the UK Corporate Governance Code (“the Code”) and new guidance from the FRC.


- Supplementary Guidance for Directors of Banks on Solvency and Liquidity Risk Management and the Going Concern Basis of Accounting.

- In the annual report, the Code now requires directors to:
  - Confirm 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 (new Provision D.2.1).
  - Describe the principal risks and explain how they are being managed or mitigated (new Provision C.2.1).

- In a new viability statement in the annual report (new Provision C.2.2) directors should:
  - Take account of the company’s current position and principal risks, explain how they have assessed the prospects of the company, over what periods they have done so and why they consider that period to be appropriate.
  - State whether 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.

- The board should also:
  - Monitor the company’s risk management and internal control systems on an ongoing basis (revised Provision C.2.1. now Provision C.2.3).
  - At least annually, carry out a review of the effectiveness of these systems and report on that review in the annual report (revised Provision C.2.1. now Provision C.2.3).
Explain in that report what actions have been or are being taken to remedy any 'significant failings or weaknesses' identified (section 6, para 58 of the new Guidance).

The FRC has kept the requirement for directors to make a 'going concern statement':

- The statement should be disclosed in the annual and half-yearly financial statements, as this is important for shareholders and other users of accounts.
- However, Provision C.1.3 is amended to clarify that the requirement is to state whether the directors consider it appropriate to adopt the going concern basis of accounting (i.e. in the financial statements), and to identify any material uncertainties about 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.

- By contrast, the new viability statement requires companies to provide meaningful discourse, tailored to their specific circumstances, of their longer-term viability. Except in rare circumstances, the FRC expects the period for this statement to be 'significantly longer than 12 months from the date of approval of the financial statements'.

- Annex B to the Guidance explains that:
  - The viability statement should be based on a robust assessment of the principal risks that would threaten the company's business model, future performance, solvency or liquidity - including its resilience to the threats to its viability posed by those risks in severe but plausible scenarios.
  - The assessment should include sufficient qualitative and quantitative analysis and be as thorough as judged necessary to make a soundly based statement.
  - Stress and sensitivity analysis will often assists directors in making their statement. Directors should consider the individual circumstance of the company in tailoring appropriate analysis, which should be undertaken with an appropriate level of prudence (e.g., reverse stress testing from the point of failure).

- The period of time used in the assessment is a matter for board judgement, taking into account company specific features such as the nature of the business and its investment and planning cycles.

- Directors should also note that the FRC has now included in the Guidance an explanation of how the Companies Act 2006 Safe Harbour Provision relate to the Strategic Report, Remuneration Directors’ Report and Directors’ Remuneration Report.

Our viewpoint

- We are developing an in-depth POV on how the new provisions will operate in practice. We will tell you more about it in the next NWK.

- In meantime, we think that some of the practical issues for companies will include determining the adequacy of existing risk management and reporting systems, to meet the new Code requirements.

- Directors will have to consider what processes, evidence, skills (e.g., scenario planning) and "period of time" will give them the confidence they need to make their longer-term viability statements.

Revitalising rem com

Revisions made to the UK Corporate Governance Code (“the Code”) in 2014 include changes to its provisions on executive remuneration. In particular:

- 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 (new Principle D.1).

- Performance-related remuneration schemes for executive directors should include provisions that enable the company to recover
sums paid or withhold the payment of any sum, and specify the circumstances in which it would be appropriate to do so (amendment to Provision D.1.1).

- The remuneration committee should:
  - Avoid paying more than is necessary (amended Supporting Principle D.1).
  - 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 (amendment to Supporting Principle D.2).
- The chairman of the board should also ensure the remuneration ‘committee chairman’ (previously the ‘company’) maintains contact as required with its principal shareholders about remuneration (amendment to Supporting Principle D.2).
- There are also a number of changes to Schedule A of the Code, which sets out the design of performance-related remuneration for executive directors. In particular, the remuneration committee should:
  - Determine an appropriate balance between fixed and performance-related, immediate and deferred remuneration.
  - Include non-financial metrics where appropriate in performance conditions.
  - Ensure remuneration incentives are compatible with risk policies and systems.
  - Consider requiring directors to hold, for share-based remuneration, a minimum number of shares for a further period after vesting or exercise, including a period after leaving the company.
- The revised text also provides that shares granted, or other forms of deferred remuneration, should not vest ‘or be paid’ in less than three years and that ‘longer periods may be appropriate.’

**Our viewpoint**

- We recognise that primacy must be given to promoting the long-term success of a company, as per the Code’s new principle on remuneration. However, remuneration packages should also be appropriately balanced to recognise the achievement of both near term milestones and long-term success.
- In light of the revisions made to the Code, including the recovery or withholding of pay, companies will need to consider how to introduce such provisions (or explain their absence). Some of these changes are emotive, so companies will need to tread carefully to ensure shareholders and executives remain aligned.

**Uncovering shareholder dissent**

The UK Corporate Governance Code ("the Code) includes revised provisions on shareholder engagement:

- An amendment has been made to Provision E.2.2 to provide that when, in the opinion of the board, a significant proportion of votes has been cast against any resolution at any general meeting, the company should explain what actions it intends to take to understand the reasons behind the vote.
- In addition, Provision E.2.4 has been revised to include a requirement that the meeting notice and related papers should be sent to shareholders and others 'at least 14 working days in advance' of a general meeting other than an AGM.

**Our viewpoint**

- In our publication Shareholder engagement and corporate reporting at a crossroads, we stressed the importance of shareholder engagement. A good dialogue should precede any vote, so ideally companies should not have any surprises at the voting stage.
- Companies will, therefore, need to review and enhance how they engage with shareholders, particularly retail shareholders. In case agreement cannot be reached, companies will
also need to decide on what constitutes a significant proportion of votes.

**UK Corporate Governance Code 2014**

**Guidance on risk management, internal control and related financial and business reporting**

**Guidance for the directors of banks, on solvency and liquidity risk management and the going concern basis of accounting**

**Diversifying diversity**

The importance of diversity in the boardroom is under the spotlight in both the UK and EU. This has led to an increase in the number and diversity of reports on the subject, including recent examples outlined below.

- On 24 July 2014 The Equality and Human Rights Commission (the “Commission”) published guidance for boards and headhunters on a range of steps to improve gender balance on boards, called *Appointments to Boards and Equality Law*.

- The following month its inquiry got underway into the recruitment and appointment of directors to the boards of FTSE 350 companies.
  
  - It will investigate appointments made in the past 12 months to assess key decision points and the roles and practices of decision makers in the recruitment process.
  
  - References will be made to the Equality Act 2010 and UK Corporate Governance Code, to gauge what changes may be necessary in the practices of search, selection and boardroom appointments.

- In June 2014 the Presidency of the EU issued a progress report on the Parliamentary approved proposal for a ‘Women on Boards Directive’.
  
  - The proposal includes an objective for listed companies to achieve 40% female representation on their boards by 2020 (2018 in the case of public undertakings).

- In September the FRC, as noted in a previous article, refreshed the preface to the 2014 Corporate Governance Code to include sufficient board diversity (including, but not limited to, gender and race) as one of the ways of encouraging constructive and challenging dialogue.

**Our viewpoint**

- Targets with teeth are needed to keep gender diversity at top of the boardroom agenda. This is because progress on gender diversity continues to be slow.

- The last report from the Davies Review (see NWK Issue 6) is a reminder that there is still a long way to go before the UK can claim victory.

- In our experience diversity needs constant close attention for any sustainable change to take place. It needs to be on the board’s agenda on a daily basis.

**Appointments to boards and equality law**

**Official notice of inquiry**

**Reporting**

**Trust in transparency**

The Government’s final proposals to enhance transparency and trust are now included in the Small Business, Enterprise and Employment Bill, which received its second reading in the Commons on 16 July. The Bill has now been committed to a Public Bill Committee, which has requested written evidence on any aspects of the Bill.

The Bill includes, amongst other other things:
A requirement for UK companies - expect companies with shares admitted to trading on UK regulated or prescribed markets - to keep a register of "people with significant control" (a PSC register) that is available for inspection.

The protection of a person of significant control's usual residential address and date of birth, and regulations to protect other particulars where persons are at significant risk of harm.

An option for private companies to keep their PSC information on public registers at Companies House.

The abolition of bearer shares and a prohibition on corporate directors (with limited exemptions to be set out in secondary legislation).

The application of the general duties of directors to shadow directors.

The Committee met for the first time on 14 October 2014 and will accept written evidence until the end of the committee stage. The committee is expected to report to the House of Commons on 6 November 2014.

Our viewpoint

EY supports the UK Government's commitment to increasing corporate transparency and the international work (including EU) that is taking place in this regard.

We support the exclusion of UK listed companies from the PSC register requirements where such companies are subject to the Financial Conduct Authority's Disclosure and Transparency Rules.

We note, however, that the EU Parliament's position on the proposals for a 4th Money Laundering Directive (4MLD) would require every member state to maintain publically available ultimate beneficial ownership registers for all companies (including listed companies and trusts). The proposals for 4MLD are now in trialogue.

Request for written evidence

Final countdown for Accounting Directive

In June 2013 the EU Parliament and Council approved a new Accounting Directive (see NWK Issue 4) to improve the comparability of financial reporting and reduce the reporting obligations of smaller companies across the EU. It also introduces country-by-country reporting (CBCR) for companies in the extractive industries.

The UK government is required to implement the Directive by July 2015, but it has now decided to introduce CBCR six months earlier (i.e. by January 2015).

The government is also consulting on its transposition of the other articles in the Directive and proposes, amongst other things, to:

- Take up the option to maximise the threshold for determining the size of "small companies", allowing approx. 11,000 additional companies to access a lighter-touch financial reporting framework.
- Consider whether small companies should be permitted to prepare an abbreviated balance sheet and profit and loss account.
- Review the exclusion of public companies from the small company regime and the medium-sized company regime.
- Explore the opportunities offered by the option to provide greater flexibility in the layout of the profit and loss account and balance sheet.
- Require that information on subsidiaries included with the consolidated financial statements is only provided as a note to those statements;

Small Business, Enterprise and Employment Bill
Our viewpoint

- The approach to CBCR 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.

- Other requirements to reduce reporting requirements on smaller companies seem, in principle, a welcome move as long as other Member States implement the changes consistently.

- EY is reviewing the BIS consultation on the UK’s proposed implementation of Chapters 1-9 of the Accounting Directive and will be submitting a response in due course.

UK Implementation of the EU Accounting Directive

Taking over with the best of intentions

From 24 October 2014 the Takeover Panel (“Panel”) will review its latest proposals to change the Takeover Code (“Code”). This is prompted by the fallout from Pfizer’s attempt to take over AstraZenica in May 2014.

- The Code currently regards a statement of intention made by a company (offeror), seeking to take over another company (offeree), as a binding commitment to the offeree. But the Code does not distinguish between a voluntary commitment and a statement of intent. Neither does it cover the circumstances in which the offeror may withdraw its intention.

- To address these uncertainties, the Panel proposes to introduce a new framework for the regulation of statements made by offerors, by distinguishing between:

  - Post-offer undertakings: these would refer to a course of action that an offeror commits to take, or not take, after the end of the offer period.

  - Post offer intention statements: these would refer to statements relating to any course of action that an offeror intends to take, or not take, after the end of the offer period.

- By introducing these changes the Panel aims to enhance the way it monitors and enforces compliance with post-offer undertakings by:

  - Requiring the offeror, that makes certain undertakings, to provide periodic written reports to the Panel.

  - Enabling the Panel to require the appointment of an independent supervisor, to monitor compliance with a post-offer undertaking.

Our viewpoint

- Any measures that help to remove uncertainty, in terms of post-offer undertakings or intentions, should in principal be welcomed by offerees.

- We encourage the Panel to publish guidance on the periodic reporting of undertakings, so offerors affected by this requirement can be certain of the frequency and scope of these reports.

Takeover Panel: Post offer undertakings and intention statements

Auditing

CMA’s final Order for UK audit

On 26 September 2014 the Competition and Markets Authority (CMA) finally published its Order for the UK audit market (see NWK issues 4 & 5). It takes effect from the 1 January 2015 and applies to UK incorporated FTSE 350 companies.

- The Order falls under the ambit of the Enterprise and Regulatory Reform Act 2013. Any person who suffers loss or damage due to a breach of the Act may bring legal action against the company concerned, and the CMA can seek to enforce the Order by civil proceedings.
Mandatory tendering

- A key aspect of the Order is the introduction of mandatory tendering, to ensure FTSE 350 companies put their statutory audit out to a competitive tender at least once every ten years (Article 3.1(a)).

- The Order aligns transition to mandatory tendering (Article 6) with the EU's transitional rules for mandatory audit firm rotation. The EU's rules came into force on 16 June 2014 and take effect from 17 June 2016.

- The following transition examples refer to a FTSE 350 company incorporated in the UK with a 31 December year end.
  - If the incumbent auditor (as at 16 June 2014) was appointed before 16 June 1994 the company is required to switch auditor for 2021 (EU requirement) by inviting and evaluating bids from two or more firms using a competitive tender process (CMA and EU requirement).
  - If the incumbent auditor (as at 16 June 2014) was appointed between 16 June 1994 to 16 June 2003, the audit has to be switched for 2024 (EU requirement) by inviting and evaluating bids from two or more firms using a competitive tender process (CMA and EU requirement).
  - If the incumbent auditor (as at 16 June 2014) was appointed at any time between 2003 and 16 June 2007, the company will be required to tender their auditor for the first financial year beginning on or after 17 June 2016 (EU requirement and CMA Order requirement).
  - However, note that under EU rules the company may be required to rotate their auditor at this point (EU requirement) unless the UK adopts 20 year tenures and legislates accordingly before 17 June 2016 (EU derogation).
  - If the incumbent auditor (as at 16 June 2014) was appointed on or after 17 June 2007, the company will be required to tender their auditor when its auditor has been appointed for 10 consecutive financial years.

- For example, if the auditor was first appointed for financial year 2009, the company will be required to tender their auditor for financial year 2019, based on the assumption that the UK adopts 20 year tenures (EU derogation).

- Companies are encouraged to seek legal advice on the timing of their tenders.

Audit committee responsibilities

- If a competitive tender process to appoint an auditor has not been completed for five consecutive financial years, the audit committee ("committee") must state in year five (and in subsequent years until the tender) when it intends to conduct such a tender (Article 4).

- This must be disclosed in the committee's report (or elsewhere in the annual report) with an explanation as to why that period is in the best interests of shareholders. The disclosure should be repeated every subsequent year until the year of tender, or an explanation provided if that date is no longer appropriate.

- The Order is unclear as to when the five-year clock starts, but in line with the spirit of the Order it would be prudent for audit committees to make the first of such disclosures from 1 January 2015, if they have not tendered in the previous five years.

- Committees should provide bidders with information that allows them to understand the company's business and type of statutory audit to be conducted. Examples include the planning, execution and findings of the incumbent auditor, and details on the time, resource and scope of that audit.

- Other responsibilities for the audit committee cover: i) negotiating and agreeing the statutory audit fee; ii) initiation and supervision of a competitive tender process; iii) influencing the appointment of the audit engagement partner; iv) making recommendations to the board on the auditor
appointment; v) authorisation of non-audit services (“NAS”); and the option of setting a policy for the pre-approval of NAS, including thresholds for permitting low-value NAS.

Monitoring and compliance

- FTSE 350 companies must provide a statement of compliance with the Order in the committee report (or elsewhere in the annual report) for each financial year (Article 7.1). In addition, the CMA may request information from an auditor in relation to each of its FTSE 350 audit clients. This has to be provided within 15 working days of the request being made (Article 7.2).

Our viewpoint

- The CMA’s Order has added to the complexity of audit tendering in the UK, given that it has introduced its requirement for mandatory tendering alongside the EU’s requirements for mandatory audit firm rotation.

- This could catch companies unaware, because although the CMA has sought to align the transition of its tendering with the EU’s rules for rotation, the former is based on the last date of tender, whereas the latter refers to the length of tenure.

- Some companies might have tendered recently without realising that they may have to tender again to meet the requirements of the EU’s regulations.

Questions worth asking

How will your board satisfy itself that, when reviewing the company’s risk management and internal control systems, it is getting an enterprise-wide view of how well those systems are embedded throughout the organisation and, in particular, its foreign subsidiaries?

How well defined are your company’s risk appetite processes and measurements? Will they allow you to conduct a robust assessment of the principal risks facing the company and how they are being managed or mitigated?

Have the boards of “smaller” public companies sounded out their stakeholders first, before deciding whether to publish less detailed accounts?

Is the board’s takeover strategy, in terms of post-offer undertakings, still workable given the likelihood of greater regulatory scrutiny?

Is the audit committee prepared to disclose, perhaps as early as 1 January 2015, when it will put the audit out to tender?

Are members of the audit committee ready and able to undertake a “competitive audit process” as defined by the CMA?

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?
Other developments worth noting

IMA issues its principles of remuneration (LINK)

FRC formalises an increase in the transparency of its review of company accounts (LINK)

FRC publishes its annual review on UK corporate reporting (LINK)

International Corporate Governance Network publishes the 4th edition of its governance principles (LINK)

Financial Reporting Lab publishes guidance on producing clear and concise annual reports (LINK)

Financial Reporting Lab publishes guidance on accounting policies and the integration of related financial information (LINK)

International Organisation of Securities Commissions publishes a statement on the use of non-GAAP financial measures (LINK)

European Commission assess current EU legal framework for the cross-border operations of companies (LINK)

FRC announces its proposed use of existing reporting standards to meet requirements of the EU’s Accounting Directive (LINK)

European Financial Reporting Advisory Group publishes its report on the role of the business model in financial statements (LINK)

Investment Management Association issues share management capital guidelines (LINK)

Association of British Insurers publishes views on equity capital market transactions, following the 2013 report on improving corporate governance and shareholder engagement (LINK)

For further information, please contact the EY Corporate Governance team, or call your usual EY contact.
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