Looking to the future

The 2014 revisions to the UK Corporate Governance Code

On 17 September 2014, the Financial Reporting Council (FRC) confirmed the changes to the UK Corporate Governance Code (the ‘Code’) arising from its latest biennial review. The 2014 Code applies to financial reporting periods beginning on or after 1 October 2014.

This update highlights some of the key changes and also a number of questions that directors of UK and overseas Premium Listed companies, and other entities applying the Code voluntarily (Code companies), may find it helpful to consider as they prepare for implementation.

Introduction

The changes to the Code largely reflect the proposals in the FRC’s April 2014 consultation – which followed earlier consultations on Directors’ Remuneration (October 2013) and Risk management, internal control and the going concern basis of accounting (November 2013). They relate to:

- Executive directors’ remuneration.
- Risk management, internal control and going concern.
- Relations with shareholders.

These changes ‘are designed to strengthen the focus of companies and investors on the longer term and the sustainability of wealth creation.’

The FRC has also taken the opportunity to highlight, in the refreshed Preface to the 2014 Code, the importance of:

- The board’s role in establishing the culture, values and ethics of the company and the correct ‘tone from the top’.
- 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).

In particular, Code companies will need to:

- Ensure executive directors’ remuneration is designed to promote the long-term success of the company and have appropriate arrangements in place to recover or withhold variable pay;
- Include a new, longer-term, viability statement in the annual report (e.g., in the Strategic Report), ‘to provide an improved and broader assessment of liquidity and solvency.’ Boards will be responsible for determining the period covered by the statement and explaining why this period is appropriate.
- Explain how they intend to engage with shareholders when a significant proportion of votes have been cast against a resolution at any general meeting.

The FRC has also published, following consultations in January 2013 and November 2013:

- **Guidance on Risk Management, Internal Control and Related Financial and Business Reporting (the ‘Guidance’), which will replace both the Going Concern Guidance (2009) and the ‘Turnbull’ Guidance on Internal Control (2005).**
- **Supplementary Guidance for Directors of Banks on Solvency and Liquidity Risk Management and the Going Concern Basis of Accounting.**
- **Revised extracts from International Standards on Auditing (UK and Ireland) 260, 570 and 700, which include the requirement to report as to whether the auditor has anything material to add or, to draw attention to, in relation to the statement on the directors’ assessment of the principal risks that would threaten the solvency or liquidity of the entity.**

The Guidance is intended to assist directors in applying Section C of the Code.

Key changes in specific areas of the Code are highlighted below.

1. **Executive directors’ remuneration**
   - 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 would 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 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 to 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.

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4 Implementing the recommendations of the Sharman Panel – Revised Guidance on Going Concern and revised International Standards on Auditing (UK and Ireland).
5 Risk management, internal control and the going concern basis of accounting.
Ensure remuneration incentives are compatible with risk policies and systems.

Consider requiring (For share-based remuneration) directors to hold a minimum number of shares and, to hold shares for a further period after vesting or exercise – including for 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.’

2. Risk management, internal control and going concern

In the annual report, the directors should:

- 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 C.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) the directors should:

- Taking 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 their effectiveness, 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 Guidance).

The FRC has retained the requirement for directors to make a ‘going concern statement’ in the annual and half-yearly financial statements, as this is important for shareholders and other users of accounts. However, it has amended Provision C.1.3 to clarify that the requirement is to state whether they consider it appropriate to adopt the going concern basis of accounting (i.e., in the financial statements) and to 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.

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

Annex B to the Guidance (Longer Term Viability Statement) 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. The Guidance explains that stress tests and sensitivity tests will often assist the directors in making their statement. Directors should consider the
individual circumstances of the company on tailoring appropriate analysis, which should be undertaken ‘with an appropriate level of prudence’ (e.g., reverse stress testing from the point of failure).

Directors are encouraged to think broadly as to relevant matters that may threaten viability, including risks to solvency and liquidity and any mitigating actions and their likely effectiveness. This will be informed by the board’s regular monitoring and review of risk and internal control systems.

The Guidance also clarifies that ‘reasonable expectation’ does not mean ‘certainty’ but does mean the assessment can be justified. The longer the period considered, the more the degree of certainty can be expected to reduce. The period of time used in the assessment is, however, a matter for board judgement, taking into account company specific factors such as the nature of the business and its investment and planning periods.

Directors may wish to consider, if appropriate, linking the viability assessment process to the company’s business and strategic planning cycle, as considered by the board.

Directors should also note that the FRC has now included in the Guidance, an explanation of how the Companies Act 2006 safe harbour provision relates to the Strategic Report, Directors’ Report and Directors’ Remuneration Report.

Companies can choose where to put the risk and viability disclosures, and if included in the Strategic Report, these will be covered by the safe harbour provision. Directors should consider whether and how to link reporting on the review of the risk management and internal control systems to the information on principal risks in the Strategic Report and material uncertainties relating to the going concern basis of accounting in the financial statements.

3. Relations with Shareholders

The key change to Section E of the Code is an amendment to Provision E.2.2 to provide that when, in the opinion of the board, a significant proportion of votes have been cast against any resolution at any general meeting (not just an AGM), the company should explain when announcing the results of voting what actions it intends to take to understand the reasons behind the vote result.

In addition, Provision E.2.4 has been revised to include a requirement that the 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.

6 Section 6, paragraph 61 to 65 of the Guidance.
Some questions for directors to consider:

Remuneration

► Do remuneration arrangements include sufficient provision to recover sums paid to executive directors? Are the circumstances in which it would be appropriate to make such recoveries adequately specified?

► What is an ‘appropriate balance’ between ‘immediate’ and deferred remuneration for executive directors and does the company’s existing remuneration policy strike the right balance?

► Has the remuneration committee considered what constitutes an appropriate minimum shareholding for executive directors? Should deferred remuneration be subject to post-vesting holding periods and, if so, should the holding periods apply both during and post employment?

The viability statement

► Given the nature of your company’s operations and the economic cycle it is exposed to, what is an appropriate period for the board to make the viability statement in respect of, and does the board have the information it needs for that period?

► As a board and executive team, what processes and evidence will you need to employ to have the confidence to make the longer-term viability statement?

► What skills will be needed to make the viability statement a realistic assessment of the longer term risks faced by the company, particularly around stress testing, scenario planning and evaluating whether the actions to be taken to offset those longer term risks are sufficient?

Risk management and internal control

► How will the 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?

► Do the directors have a definition of what would constitute a ‘significant’ failing or weakness in risk management and internal control systems? What processes exist to consider such failings and weaknesses?

► How well defined are your company’s risk appetite processes and measurements, to enable a robust assessment of the principal risks facing the company to be made including how they are being managed or mitigated?

Relations with shareholders

► How will the company decide on what constitutes a significant proportion of votes and how will it engage with shareholders, particularly retail shareholders?
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