



Governance in brief

Promoting excellence in the boardroom

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FRC publishes revised UK Corporate Governance Code and Guidance on Audit Committees

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FRC publishes revised UK Corporate Governance Code and Guidance on Audit Committees

In brief: In the latest stage of the process to implement the recommendations set out in the Effective Company Stewardship papers, the FRC has published revised editions of the UK Corporate Governance Code (“the Code”) and the Guidance on Audit Committees (“the Guidance”). Some of these changes relate to the board and the audit committee’s interaction with the external auditor which are supported by related amendments to International Standards on Auditing (UK and Ireland).

The proposals are effective for periods commencing on or after 1 October 2012, so for a company with a December year end, the revised Code will be applicable for the 31 December 2013 year end.

Adopt early?

Companies may adopt some of the new provisions early if they wish. We have set out below points to consider.

New, far-reaching board statement on the content of the annual report and accounts

The word “fair” has been added to the principle in section C.1 of the Code on Financial and Business Reporting which sets out that:

“The board should present a fair, balanced and understandable assessment of the company’s position and prospects.”

To further reinforce this principle of the Code, Code provision C.1.1 has been extended as indicated by the *italicised* text below:

“C.1.1 The directors should explain in the annual report their responsibility for preparing the annual report and accounts, *and state that they consider the annual report and accounts, taken as a whole, is fair, balanced and understandable and provides the information necessary for shareholders to assess the company’s performance, business model and strategy.* There should be a statement by the auditor about their reporting responsibilities.”

In our opinion the addition of the word “fair” in addition to the requirement for the assessment to be “balanced”, conveys a need for the assessment not to exhibit any bias, in other words to be reasonable and impartial. A further interpretation of “fair” could be in relation to the assessment being prepared properly.

Code Provision C.3.4 (see below) says that the board may wish to ask the audit committee for their advice in this area.

Adopt early?

There are two aspects of this additional wording:

First, whether the annual report is “fair, balanced and understandable”?

- We believe the board will need to be satisfied that all the matters it has considered and which have been brought to its attention during the year have been reflected adequately in the annual report. This does not mean that every matter is specifically referred to in the annual report but that the relevant impacts, uncertainties and outcomes arising from these matters have been included where appropriate.
- The board should consider whether there are any areas where they require more information to decide if the annual report is fair, balanced and reasonable, and make arrangements for this information to be reported to them.

Once the board is satisfied, suitable wording could be along the following lines: “Having taken all the matters considered by the board and brought to the attention of the board during the year into account, we are satisfied that the annual report and accounts, taken as a whole, is fair, balanced and understandable.”

Second, deciding whether to go early with the confirmation that the annual report includes the information necessary for shareholders to assess the company’s performance, business model and strategy. This may be more challenging:

- Whilst many companies are used to using key performance indicators to explain their financial and non-financial performance, our experience is that the quality of business model and strategy disclosures is more variable. For those companies which have not yet been able to articulate their business model and strategy in the annual report, there is further work to be done. Deloitte will be publishing a methodology to assist with disclosure of the business model in October.
- If the board feels that it is able to make this disclosure, our experience is the necessary material is often spread across several sections of the annual report and it may be helpful to clarify this to readers, e.g. “The board believes that the disclosures set out on pages X to X of this annual report provide the information necessary for shareholders to assess the company’s performance, business model and strategy.”

The supporting principle relating to interim reports and public and regulatory reports has also had the word “fair” added and boards may need to revisit their processes to approve these in a similar fashion.

Any project plan to deal with these new disclosures could usefully be integrated with the work needed to comply with the forthcoming changes to narrative reporting. Final details are due to be published by the government in October and we will update you at that time.

New and further responsibilities for the audit committee

Amended Provision C.3.2 places a new duty on the audit committee to report to the board on how it has discharged its responsibilities. The Guidance on audit committees also recommends that the following specific matters are reported to the board by the audit committee:

- the significant financial reporting issues and judgments made in connection with the preparation of the company's financial statements, interim reports, preliminary announcements and related formal statements; and
- the effectiveness of the external audit process.

In addition Code Provision C.3.4 says that, where requested by the board, the audit committee should review the content of the annual report and accounts and advise the board whether, taken as a whole, it is fair, balanced and understandable and provides the information necessary for shareholders to assess the company's performance, business model and strategy – in other words to advise the Board on their application of Code Provision C.1.1.

Adopt early?

The audit committee should seek confirmation in good time from the board as to whether they will be asked to advise on Code Provision C.1.1. If the board will be seeking advice from the audit committee, then the audit committee will need to consider the matters set out above under "New, far-reaching, board statement on the content of the annual report and accounts". In addition, the Guidance recommends that the audit committee would need to assess whether the narrative in the front of the report was consistent with the accounting information in the back, so as to ensure that there were no surprises hidden in the accounts. This point should be added to the agenda for the audit committee meeting which considers the final report.

For entities applying the revised Code, the auditor will be required to communicate information to the audit committee that will be relevant to the board and the audit committee in fulfilling their responsibilities under C.1.1, C.2.1, C.3.2 and, where relevant, C.3.4. Audit committees will want to discuss how this will work with the auditor as part of the planning process for the external audit.

New Provision C.3.8 requires that:

- "A separate section of the annual report should describe the work of the audit committee in discharging its responsibilities. The report should include:
 - the significant issues that the committee considered in relation to the financial statements, and how these issues were addressed;
 - an explanation of how it has assessed the effectiveness of the external audit process and the approach taken to the appointment or reappointment of the external auditor, including the length of tenure of the current audit firm and when a tender was last conducted; and
 - if the external auditor provides non-audit services, an explanation of how auditor objectivity and independence is safeguarded."

This provision introduces a new element of disclosure on the significant issues considered and elevates guidance previously included in the Guidance on the external auditor relationship to a Code Provision.

Adopt early?

The Guidance suggests that, when considering their explanation of the significant matters considered and how these were addressed, the audit committee should have regard to the matters communicated to it by the auditors in accordance with their responsibilities under auditing standards. Auditing standards are being changed to require the auditor to communicate the rationale and evidence relied upon when making significant professional judgments in the course of the audit and reaching an opinion on the financial statements.

Audit committees will need to use their judgment in distilling the information provided by auditors on significant issues into an appropriate level of detail for presentation to the board and in the annual report. We do not expect extensive disclosures in this area but a flavour of some of the significant issues considered, and how they were addressed, should be presented. Examples of companies whose audit committees are already doing this include Barclays, Pearson and Vodafone.

As auditors will also be required to report to shareholders if they do not believe that the audit committee report appropriately addresses matters communicated to the audit committee by the auditor, audit committees will want to have an initial discussion as to what those areas might be at the time that the audit plan is discussed with the auditors. Whilst new issues may emerge during the audit, or through the passage of time, this will often provide an initial list of issues to use as a starting point for drafting the audit committee report. It will be important to ensure that there is some consistency between these significant issues and the disclosures on critical judgments and key sources of estimation uncertainty in the financial statements.

Many companies already provide extensive disclosures in relation to the provision of non-audit services by their auditor and how auditor objectivity and independence is safeguarded. Our financial reporting surveys show that far fewer companies provide information regarding tendering frequency and how the effectiveness of the audit process has been assessed. The majority of audit committees will be having these conversations and undertaking this assessment, therefore incorporating a summary in a report to the board and in the annual report should not be problematic.

As set out above, corresponding changes to the International Standards on Auditing (UK and Ireland) to support these changes to the Code and the Guidance may require auditors to communicate additional information to boards and/or audit committees, and auditors will have new duties to report by exception if they believe:

- the statement made under Provision C.1.1 (or their explanation for non-compliance with that Provision) is inconsistent with the auditor's knowledge acquired during the audit; and
- the audit committee's report does not appropriately address matters communicated to them by the auditor.

These matters will become a regular part of the audit committee/auditor discussions during the course of each year and sufficient time should be allocated for consideration of these points in the audit timetable.

Audit tendering

The following sentence on audit tendering has been added to Provision C.3.7:

“FTSE 350 companies should put the external audit contract out to tender at least every ten years.”

In order to ensure that this provision can be introduced without significant disruption the FRC has provided details of transitional arrangements on its website as follows:

“The FRC suggests that the timing of tenders might be aligned with both the cycle for rotating the audit engagement partner and the length of time since the audit contract was previously put out to tender. Where a company has put the audit contract out to tender or changed audit firm in or after 2000, the tender process might be deferred until the latter stages of the incoming audit engagement partner’s term (in other words, for a further five years).

So, for example, under these suggested arrangements, if the current audit partner was due to complete their five year period in 2014 the company would carry out a tender in time for the successful audit firm (which could be the incumbent firm) to take up their appointment when that partner steps down. However if the company had carried out a tender or changed audit firm more recently than 2000, this could be deferred until the next partner rotation in 2019.”

Source: <http://www.frc.org.uk/Our-Work/Codes-Standards/Corporate-governance/UK-Corporate-Governance-Code.aspx> and scroll down to ‘Audit Tendering’ section.

Setting out these transitional arrangements, the FRC was keen to stress the following points:

- The suggested transitional arrangements are not binding.
- Companies should put the audit contract out to tender if they feel it is appropriate to do so, and shareholders should feel free to request them to do so.
- As with all other provisions of the Code, companies can choose not to comply and explain why not.
- The FRC would encourage companies to state when they first report against the 2012 Code whether or not they anticipate putting the audit contract out to tender in due course.

Appointments to the board – diversity and use of executive search consultancies

Additions have been made to Provision B.2.4 in the ‘Appointments to the board’ section of the Code. The revised Provision says that the section of the annual report describing the work of the nomination committee should include:

- a description of the board’s policy on diversity, including gender, any measurable objectives that it has set for implementing the policy, and progress on achieving the objectives; and
- where an external search consultancy has been used, the identity of that consultancy together with details of any other connection with the company.

Adopt early?

The FRC “strongly encouraged” early adoption of the diversity provisions of the revised Code when they were first announced in October 2011. Consider:

- where there is an existing board diversity policy and/or an executive search consultancy has been used, including the required details in the nomination committee report or corporate governance statement; or
- if there is no board diversity policy, commencing discussions with a view to developing a policy for approval by the board.

Following on from the change to Provision B.2.4 in relation to diversity, supporting principle B.6 on Evaluation has also been supplemented as follows:

“Evaluation of the board should consider the balance of skills, experience, independence and knowledge of the company on the board, its diversity, including gender, how the board works together as a unit, and other factors relevant to its effectiveness.”

Adopt early?

Review board evaluation practices to ensure that these aspects of its performance and composition are considered as part of the annual performance evaluation exercise.

In line with the change to Provision B.2.4 described above, Provision B.6.2 has been amended to require similar disclosure about any external facilitator used in the board evaluation process:

“The external facilitator should be identified in the annual report and a statement made as to whether they have any other connection with the company.”

Adopt early?

Consider including these extra details in the section of the report which deals with board performance evaluation and the use of an external facilitator. Given the new disclosure on the external facilitator’s connection with the company, if there are any concerns about the facilitator’s independence, these should be addressed at the earliest opportunity.

Meaningful explanations of non-compliances with the Code

The FRC is keen to ensure that meaningful explanations of all non-compliances with the provisions of the Code are provided which illustrate how the actual governance practices are consistent with the principle to which the particular provision relates, contribute to good governance and promote delivery of business objectives. A new section has been included in the preamble to the Code which describes the following characteristics of a meaningful explanation:

- a clear rationale for the action it is taking;
- a description of any mitigating actions taken to address any additional risk and to maintain conformity with the relevant principle; and
- where the deviation from the Code’s provision is intended to be limited in time, an explanation indicating when the company expects to conform with the provision.

Adopt early?

Boards of companies intending to ‘explain’ one or more non-compliances should review their planned explanations against each of the characteristics set out above. The Financial Reporting Review Panel’s 2012 Annual Report shows that the FRC’s Conduct Committee will be focusing on the quality of explanations in the next reporting season.

Acknowledging other providers of capital

In the Preface to the Code, Chairmen are now encouraged to recognise the contribution made by providers of capital other than shareholders and confirming the board's interest in listening to the concerns of such providers, insofar as these are relevant to the company's overall approach to governance.

Adopt early?

Consider including a reference to other providers of capital (for example bond holders), the contribution they make in providing capital for the company and details of any steps taken by the board to understand their concerns.

Date: 28 September 2012

Source: The Financial Reporting Council

Further info: <http://www.frc.org.uk/News-and-Events/FRC-Press/Press/2012/September/FRC-publishes-updates-to-UK-Corporate-Governance-C.aspx>

Time to take action

- Boards should review these changes carefully and agree a process for implementation.
- Boards should then consider the extent to which they would like to adopt some of the changes early, particularly the enhanced disclosures by the board on the business model, strategy and diversity and by the audit committee on significant issues considered.

On the horizon

- Draft regulations from government, changing the structure of narrative reporting are expected later in the year. These changes are likely to come into effect for period ending after October 2013.
- We anticipate an Action Plan from the EC further to the Green Paper on corporate governance.

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UK Centre for Corporate Governance

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