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Revisions to the UK Corporate Governance Code, Guidance on Audit Committees and the UK Stewardship Code

CBI response to FRC consultations, July 2012

The focus of this set of revisions to the Codes should be on strengthening engagement and accountability between companies and shareholders. This can be best achieved by ensuring the Codes encourage appropriate and useful information without imposing a disproportionate burden.

The CBI welcomes the opportunity to comment on the Financial Reporting Council (FRC) consultations on these Codes and Standards. We have selected the issues that are particularly important to CBI members which are:

- Some proposals are likely to result in boilerplate language that is unhelpful to shareholders
- There is a risk that the audit committee role may be expanded too far
- The Stewardship Code revisions strengthen engagement and transparency
- Audit tendering on a 'comply or explain' basis will give shareholders a stronger voice in this important area of governance

Some proposals are likely to result in boilerplate language that is unhelpful to shareholders

The CBI supports focused, valuable and informative reporting by Boards to shareholders. We believe caution is necessary if requiring Boards to state the basis on which they consider that the annual report is 'fair, balanced and understandable'. We understand that this revision is intended to provide a check and balance against any inconsistencies in the report. However, directors are already required to explain their responsibility for preparing the annual report and accounts. The Companies Act requires the report of the directors to include a fair review of a number of pieces of information around the development and performance of the business including the risks they race. The introduction of further boilerplate language would not add anything valuable.

The CBI is unsure what the FRC expects companies to say about "the basis" on which they have concluded that the requirements are met and in what detail. It is important that changes to the Code encourage meaningful reporting for shareholders, rather than boilerplate language.

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There is a risk that the audit committee role may be expanded too far

The CBI believes there is a risk that the audit committee advising the Board on whether the annual report is 'fair, balanced and understandable' represents a delegation of responsibility that will detract from the responsibility of the Board as a whole for the annual report. Audit committees play a vital role, but it is important that their position does not undermine the unitary Board and that they are not overburdened.

If this revision is not intended to be a delegation of responsibility, then the kind of work the audit committee is expected to do, that companies would not currently do, needs to be clarified. For example, is the FRC expecting the audit committee to carry out a detailed due diligence process on the report, or are they to be more concerned with ensuring the process of drafting it is an appropriate process? The former could constitute a significant increase in the work of the committee. Any clarification of this kind should be further consulted on. Assuming this requirement is adopted, guidance should be given by the FRC as to what is expected.

We are also concerned about audit committees being required to report the 'significant issues that were considered'. To avoid audit committees providing overly lengthy reports to comply with this, only material issues and how they were resolved should be disclosed. Otherwise this provision could lead to large amounts of narrative that would not necessarily be of interest to shareholders. It is not clear how significance or materiality should be judged – by the effect on the results or by the time the committee has spent on the issue or something else? There is a risk that, if audit committees think it is unhelpful to have to report on such matters publicly, it will stifle discussions in the committee. There may also be cases where the matters discussed are confidential or the group's interests would be damaged by having to disclose them. There should be a carve out for these matters. We are also not sure on what basis the committee is to judge the "effectiveness" of the external auditor.

The above wording could be amended to 'significant issues and reflected in the financial statements' in order to address occasions where an issue has been looked at in some detail by the audit committee but was not included in the financial statements. If this was not altered several issues which were of concern to the audit committee but resulted in no changes to the results or financial position would be disclosed and would not be covered by a confidentiality clause.

In smaller companies the audit committee may be unable to cope with the proposed increased workload. It is worth considering the full scope of audit committee responsibilities to ensure the burden is manageable for these smaller firms.

The Stewardship Code revisions strengthen engagement and transparency

The CBI supports the revised Stewardship Code's push to increase engagement between investors and companies. This is ever more necessary as the UK Government introduces a binding shareholder vote on remuneration, as well as the existing annual election of directors.

The emphasis on improving the Code to encourage international investors to play a role is especially welcome, as the proportion of overseas investors owning UK companies increases. The new definition of Stewardship should help to address this. However, while it is important that the Code is accessible to overseas investors the FRC does not have a remit to compel them to sign up.

We also welcome revisions to encourage investors to be more transparent. This is especially important in relation to their use of proxy advisers and their policy. We also support the new distinction between ‘asset managers’ and ‘asset owners’ in the Code. With increased transparency for asset owners, asset managers can be held to account and communication between companies and stewards will not be one way. Requirements for asset managers to engage with companies and disclose this to the asset owners are positive changes. However, we recognise that it is optional for investors to sign up to the Code.

Audit tendering on a ‘comply or explain’ basis will give shareholders a stronger voice in this important area of governance

The CBI supports the revision to include a requirement for companies to put their audit out to tender on a ‘comply or explain’ basis at least every ten years. Audit is a critical part of corporate governance and it is appropriate for shareholders to play a role in the important decision of tendering or appointing a new auditor. This is a far more suitable policy than mandatory rotation, which would take the decision away from shareholders and could force companies to change auditor at what may be the wrong time.

In the revisions, proposals to require companies to report a year in advance of their plans to tender may cause difficulties for companies if circumstances change. We therefore welcome that this is part of the guidance and not a more rigid requirement.

More guidance would be useful on transitional arrangements, for example explaining how the rules would apply to companies who float but that have used the same auditor for over ten years, or if a company’s fluctuating share price moves it in and out of the FTSE 350. We would encourage a flexible solution.