



**FINANCIAL REPORTING COUNCIL**

**REVISIONS TO THE UK CORPORATE GOVERNANCE CODE  
AND GUIDANCE ON AUDIT COMMITTEES**

**CONSULTATION DOCUMENT**

**APRIL 2012**

## INTRODUCTION

1. The FRC announced in December 2011 that it would consult on changes to both the UK Corporate Governance and Stewardship Codes, with a view to issuing revised versions of both codes that would apply to reporting periods beginning on or after 1 October 2012.
2. This consultation document seeks views on changes to the UK Corporate Governance Code (“the Code”), and to the accompanying Guidance on Audit Committees (“the Guidance”). Consultation on changes to the Stewardship Code is being carried out simultaneously.
3. The primary purpose of this consultation is to seek views on the proposed changes to the Code and Guidance that implement the policies set out in ‘Effective Company Stewardship: Next Steps’<sup>1</sup>, published in September 2011. As a result of these changes:
  - Boards will set out in the annual report the reasons why they consider the report to be fair, balanced and understandable;
  - The remit of the audit committee will be extended expressly to advise the board on this issue;
  - More informative reporting by audit committees, including on the process for appointing the external auditor, will be encouraged; and
  - FTSE 350 companies will be expected to put the audit contract out to tender at least every ten years.

The FRC is also seeking views on any transitional arrangements that may be required in relation to tendering.

4. The FRC also proposes to set out in the Preface to the Code the features that it regards as the characteristics of an informative explanation, as discussed in the paper titled ‘What Constitutes an Explanation under “Comply or Explain”?’<sup>2</sup>, which was published in February. The purpose of this change would be to help companies understand what was expected of them when they choose to deviate from the provisions of the Code, and to provide shareholders with a benchmark against which to judge explanations.
5. In addition, there are a small number of proposed changes to address issues identified during the FRC’s monitoring of the implementation of the two codes last year.

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<sup>1</sup> The discussion paper and subsequent feedback statement can both be found at:

<http://www.frc.org.uk/about/effcompsteward.cfm>

<sup>2</sup> This paper can be found at <http://www.frc.org.uk/publications/pub2710.html>

6. It is necessary also to be clear about what the consultation document does not cover.
7. The FRC is not seeking further views on the changes relating to boardroom diversity that were announced in October 2011. These will be implemented from October 2012, and are shown in the marked-up version of the Code appended to this consultation document purely for the sake of completeness.
8. The FRC is not at this stage seeking views on the proposals relating to remuneration that the Government has asked it to consider (which were to extend the Code's existing provisions on claw-back arrangements and to limit the practice of executive directors sitting on the remuneration committees of other companies). Deferring a decision will allow the FRC to reflect on the case for changes to the Code once the Government's proposals for legislation on remuneration reporting and shareholder voting have been finalised and in light of any developments in shareholder and company practice.
9. Finally, the FRC recognises that changes may need to be made to those Code provisions that state that certain information must be disclosed in the annual report when the Government introduces its proposed new structure for narrative reporting, currently expected in April 2013. The Code may need to be amended to reflect these legislative changes and to indicate where each piece of information should be disclosed. The FRC considers that any resulting revisions to the Code would not substantially change what is expected of companies, and in those circumstances would therefore propose to reissue the Code with updated cross-references and without further consultation.
10. On timing, the FRC recognises that there is the prospect of EU level action that may overlap with some of the issues addressed in the Code. Some commentators have argued that any changes to the Code should therefore be deferred.
11. However, the FRC considers that targeted and proportionate action to improve practice at national level may help to alleviate the pressure for more prescriptive action at EU level. It also notes that, judging by the usual timetable for introducing EU requirements, any new requirements would not need to be implemented, at the earliest, until 2014 in respect of audit committees and auditor appointment and 2015 in respect of other aspects of corporate governance.

## HOW TO RESPOND

Comments on the proposed changes to the Code and Guidance set out in this consultation document are requested by 13 July 2012. Responses should be sent by e-mail to [codereview@frc.org.uk](mailto:codereview@frc.org.uk)

or in writing to:

Chris Hodge  
Financial Reporting Council  
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Aldwych House  
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It is the FRC's policy to publish on its website all responses to formal consultations unless the respondent explicitly requests otherwise. A standard confidentiality statement in an e-mail message will not be regarded as a request for non-disclosure. We do not edit personal information (such as telephone numbers or email addresses) from submissions; therefore only information that you wish to be published should be submitted.

## EXPLANATION OF THE PROPOSED CHANGES

### Effective Company Stewardship

1. In January 2011 the FRC published a discussion paper entitled 'Effective Company Stewardship - Enhancing Corporate Reporting and Audit'. The paper was issued in response to criticism of the way in which companies were seen as having failed to provide key information and sensitivities in their annual reports in the run up to the financial crisis, and related questions about whether audit was meeting user and/or public expectations.
2. In that paper the FRC put forward a series of proposals based on three principles:
  - Preparers, audit committees and auditors must ensure that all material issues are reported in a manner that is complete, neutral, free from error, fair and balanced.
  - Auditors must exercise professional judgement when undertaking audits - adopting a challenging (or appropriately sceptical) approach to key issues, assumptions and evidence.
  - Both the company and its auditor must be satisfied that the annual report (comprising the narrative report and the financial statements), taken as a whole, is fair and balanced.
3. A feedback statement was published in September 2011 reporting the outcome of consultation and setting out a series of actions that the FRC proposed to take as a result. These included:
  - Extending the remit of the audit committee to include consideration of the whole annual report, including the narrative report, with a view to determining whether it provides the information necessary for stakeholders to assess the performance and prospects of the company and whether the annual report, viewed as a whole, is fair and balanced;
  - Requiring the audit committee to report to the board on this issue, and for the board subsequently to publish this assessment in the annual report;
  - Requiring the audit committee also to report to the board, and in its own report in the annual report, the issues considered in relation to the financial statements, including any key judgements that it made, and its assessment of the effectiveness of the external audit and the approach taken to the appointment or reappointment of the external auditor; and

- Introducing a ‘comply or explain’ requirement for companies to put the external audit contract out to tender at least every ten years (which the FRC has subsequently decided should only apply to FTSE 350 companies in the first instance). The draft Guidance recommends that companies indicate their intention to put the audit out to tender in the previous annual report.
4. It is these actions that the proposed revisions to Section C of the Code and to the Guidance on Audit Committees are intended to deliver.

**Views are invited on the proposed revisions to Section C of the Code and the Guidance on Audit Committees, including whether the right balance has been struck between changes to the Code (which is subject to ‘comply or explain’) and the Guidance (which is not).**

5. The detailed wording in the draft Code differs in two respects to the actions announced in the feedback statement. The first difference is in the proposed new Provision C.1.3, which states that the board should explain the basis on which it believes the annual report is fair and balanced. In the feedback statement the FRC said that the board should also explain why it considered that the report gave users the information necessary to assess the company’s “performance and prospects”.
6. Concerns have been raised that the word “prospects” might in this context be construed as requiring companies to provide detailed forecasts of future financial performance in the report. This was not the FRC’s intention. Rather, the proposed addition to the Code is intended to encourage boards to pay more attention to the disclosures in the business review (which the Companies Act states should cover “the future development, performance and position of the company”) and on their business model and strategy. The draft new Provision C.1.3 attempts to clarify this intention.

**Views are invited on whether the proposed wording achieves the desired effect and, if not, how it might be improved.**

7. In addition, the proposed revisions include adding to Provision C.3.7 of the Code a recommendation that companies disclose the length of tenure of the current audit firm and when they last put the external audit contract out to tender. This is currently recommended in the Guidance but the FRC’s monitoring exercise in 2011 found that only about one-third of companies disclosed this information<sup>3</sup>. For this reason the FRC considers it would be appropriate to incorporate this recommendation into the Code, making it subject to the ‘comply or explain’ requirement.

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<sup>3</sup> The FRC’s report on the implementation of its two codes, ‘Developments in Corporate Governance 2011’ can be found at <http://www.frc.org.uk/publications/pub2672.html>.

8. The feedback statement also identified a number of actions addressed to auditors, which are the subject of separate consultation on revisions to the International Standards on Auditing (UK and Ireland). The proposed new requirements in these standards are cross-referred to in the draft Guidance.

#### Transitional arrangements

9. The FRC recognises that the introduction of regular tendering for the external audit contract, even on a 'comply or explain' basis, will need to be carefully managed. If all those companies that have not gone out to tender in the last ten years were to do so in the first year following the change to the Code the market would struggle to cope. It would also favour the Big 4 audit firms with their greater resources.
10. For this reason the FRC has revised its original proposal and intends only to apply the new provision to FTSE 350 companies in the first instance.
11. While this will alleviate potential problems to a certain extent, the FRC considers that transitional arrangements may be needed to ensure that the introduction of tendering is phased over a suitable period. Accordingly the FRC proposes that the timing of any tender should be linked to:
  - When the current audit engagement partner is due to rotate. Although it would be open to companies to tender at any time in the audit cycle that they consider appropriate, the FRC does not wish to promote tenders that could disrupt the existing audit engagement partner cycle; and
  - The length of time since the audit contract was previously put out to tender. The FRC proposes that where a company has put the audit contract out to tender in or after 2000, the tender process could be deferred until the latter stages of the incoming audit engagement partner's term (in other words, for a further five years).
12. The combined effect of these proposals would be to defer the date for tendering the audit contract of a significant number of FTSE 100 companies until 2018 or later. The available data suggests that, if the above approach is adopted, tendering activity might be spread across the ten years following introduction of this requirement as follows:

Year	Audit contracts to be put out to tender
2013	7
2014	12
2015	16
2016	8
2017	17
2018	8
2019	3
2020	9
2021	9
2022	11

*Note: the figures in this table are purely indicative and based on data provided by the Big 4 audit firms and the Audit Committee Institute. The FRC does not have complete data on when all audit contracts of FTSE 100 companies were last put out to tender. In addition, the figures assume that all companies will choose to comply with the proposed new provision rather than explain, and that no companies will choose to tender at an earlier stage.*

13. The FRC does not have reliable data on when the majority of FTSE 250 companies last put their audit contracts out to tender, but the data that is available suggests that at least one quarter of the current FTSE 250 companies have done so since 2000. It therefore seems unlikely that there would be a disproportionate concentration of tenders in any one year.
14. If transitional arrangements are introduced, they will be set out either in the Guidance on Audit Committees or on the FRC website.

**Views are invited as to whether the transitional arrangements outlined above are workable, and whether there are alternative arrangements that should be considered. Any data on the frequency and pattern of tendering in FTSE 350 companies would also be very welcome.**

### **The quality of explanations**

15. It is important for the continuing credibility of ‘comply or explain’ that companies provide clear and meaningful explanations when they choose to deviate from the Code, so that their shareholders can understand the reasons for doing so and judge whether they are content with the approach the company has taken.

16. In its most recent annual survey of compliance with the Code<sup>4</sup>, Grant Thornton found that 50 per cent of FTSE 350 companies reported full compliance, and that overall the FTSE 350 comply with 96 per cent of the aggregate Code provisions that apply to them. In those instances where companies chose to explain, only two thirds did so with what Grant Thornton considered to be a meaningful level of detail.
17. In order to address the issue of poor quality explanations, the FRC held two meetings with senior investors and companies in December 2011. This led to the publication of the paper titled 'What Constitutes an Explanation under 'Comply or Explain'' in February. This paper identified a number of features of a meaningful explanation. These included, for example, providing a clear rationale for the action taken and describing any mitigating actions.
18. The FRC is now proposing to refer to these features in the introductory section to the Code. The introductory section is not subject to "comply or explain", but are intended only as background and guidance. The FRC believes that it will be helpful for companies to understand what is expected of them and for shareholders to have a benchmark against which to assess explanations.

**Views are invited on whether it would be helpful to identify the features of a meaningful explanation in the introduction to the Code and, if so, whether the proposed addition correctly identifies those features.**

#### **Other proposed changes**

19. In addition to the proposed revisions summarised above, the FRC is suggesting a small number of other changes to the Code.
20. The FRC proposes adding to the Preface of the Code a reference to the interest of debt holders, and other providers of non-equity capital, in the governance of the company. While the interests of debt and equity holders sometimes diverge, both have a common interest in the long-term stability of the company, and often institutions holding equity in a company will also hold debt.
21. A reference to the interest of these holders in the Preface would mirror wording that the FRC is proposing to add to the introductory section of the Stewardship Code, encouraging investors to disclose whether they adopt a stewardship approach with regard to other asset classes in which they invest, including corporate debt.
22. In addition, a number of other changes to the Preface and the section headed 'Governance and the Code' are proposed to update or remove language specifically referring to the FRC's 2010 review of the Code and the changes subsequently made to the Code.

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<sup>4</sup> 'Corporate Governance Review 2011'; Grant Thornton; November 2011.

23. The FRC is proposing to amend Provision B.2.4 to require companies that have made use of an external search consultancy to disclose whether they have any other connection with the company. This disclosure is already required when external board reviewers or remuneration consultants are used, and there are more detailed disclosures required when the external auditor provides non-audit services. The purpose of this proposed change is therefore to ensure consistency in the way that relations with external advisers are reported.
24. The final proposed changes to the substance of the Code also relate to external advisers. As noted in the report on the implementation of the two codes issued by the FRC in December 2011, a significant minority of those companies that stated in their annual reports that the board review had been independently facilitated failed to identify the reviewer. This had led some investors to be sceptical about how “independent” the review had been in these cases. In its report the FRC stated that it considered that this information should be provided as a matter of course, and it is now proposing to make this explicit in Provision B.6.2. For the sake of consistency, the FRC is also proposing to add similar wording to Provisions B.2.4 (in respect of external search consultancies) and D.2.1 (in respect of remuneration consultants).

**Views are invited on all of these proposed changes.**

25. Some consequential amendments will also need to be made to Schedule B, which summarises the disclosure requirements in the Code and FSA rules. This schedule has not been included in the draft revised Code appended to this consultation paper. As noted in the introduction to this paper, further consequential changes may also be required to the Schedule and some provisions of the Code when the Government introduces its proposed new structure for narrative reporting, currently expected in April 2013.



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