Financial Reporting Council

September 2014

Feedback Statement - Revisions to the UK Corporate Governance Code

The FRC is responsible for promoting high quality corporate governance and reporting to foster investment. We set the UK Corporate Governance and Stewardship Codes as well as UK standards for accounting, auditing and actuarial work. We represent UK interests in international standard-setting. We also monitor and take action to promote the quality of corporate reporting and auditing. We operate independent disciplinary arrangements for accountants and actuaries; and oversee the regulatory activities of the accountancy and actuarial professional bodies.

Introduction

In April 2014 the Financial Reporting Council issued a consultation document setting out a series of proposals to amend the UK Corporate Governance Code (“the Code”) and extracts from the merged guidance on risk management and going concern. The full version of this guidance has now been published, alongside the new version of the Code, as the ‘Guidance on Risk Management, Internal Control and Related Financial and Business Reporting’. This is intended to assist directors in applying Section C of the UK Corporate Governance Code. A summary of the changes made following consultation has been included in this feedback statement.

The proposed changes to the UK Corporate Governance Code were that:

- greater emphasis be placed on ensuring that remuneration policies are designed with the long-term success of the company in mind, and that the lead responsibility for doing so rests with the remuneration committee;

- companies should put in place arrangements that will enable them to recover or withhold variable pay when appropriate to do so, and should consider appropriate vesting and holding periods for deferred remuneration;

- companies should explain when publishing general meeting results how they intend to engage with shareholders when a significant percentage of them have voted against any resolution;

- companies should state in their financial statements whether they consider it appropriate to adopt the going concern basis of accounting and identify any material uncertainties to their ability to continue to do so;

- companies should robustly assess their principal risks and explain how they are being managed or mitigated;

- companies should state whether they believe they will be able to continue in operation and meet their liabilities taking account of their current position and principal risks. They should specify the period covered by this statement and why they consider it appropriate. It is expected that the period assessed will be significantly longer than 12 months; and

- companies should monitor their risk management and internal control systems and, at least annually, carry out a review of their effectiveness, and report on that review in the annual report.

Consultation closed on 27 June 2014 and this paper summarises the main points from the responses, the decisions taken by the FRC and the reasons for those decisions. The Appendix to this feedback statement includes a table showing how the new edition of the Code differs from the 2012 edition.

The new edition of the UK Corporate Governance Code will apply to reporting periods beginning on or after 1 October 2014.

The FRC normally reviews every two years whether the Code needs to be updated. However, as noted in its April 2014 consultation document, further Code changes will be likely in 2016 as a result of the Government’s implementation of the EU Audit Directive and as follow up to the report by the Competition Commission (now the Competition and Markets Authority) on the market for audit services in FTSE 350 companies.

Summary of responses

The FRC received 78 responses to the consultation. Of these, ten were from listed companies, 13 from investors, six from audit firms, and 29 from representative bodies. The remainder came from individuals, risk managers and service providers. Copies of all responses, with the exception of those that respondents asked to be kept confidential, are available on the FRC website.

Directors' Remuneration

The consultation document proposed amending the high-level Principles in Section D of the Code to make clear that remuneration policies must be designed to deliver long-term benefit to the company. It was felt that some of the wording in the Code – for example, on the need to be able to "attract, retain and motivate" directors – were capable of being read otherwise. The proposed changes are intended to remove any doubt as to the intention.

The FRC received a significant number of comments with the vast majority of respondents supporting the changes. The word "transparent" has been added to the second sentence of the main principle in D.1 to ensure there is more clarity in relation to performance-related elements. In regard to these being "transparent, stretching and rigorously applied" the FRC expects companies to set and report on targets that do not encourage excessive risk-taking and over which remuneration committees have effective control.

The addition of a "comply or explain" provision for companies to put in place arrangements that will enable them to recover or withhold variable pay when appropriate to do so, and to consider appropriate vesting and holding periods for deferred remuneration, received a large amount of support. A number of respondents highlighted the difficulties in enforcing clawback related arrangements and while the FRC understands these, it remains important that such arrangements are established by companies. Best practice is evolving rapidly and the Code will support such developments.

The FRC has revised the wording in E.2.2 in the light of comments made in relation to companies explaining, when publishing meeting results, on how they intend to engage with shareholders when a significant percentage of them have voted against any resolution. This better expresses the original intentions while alleviating some of the concerns raised by respondents. It was not the intention that votes withheld should be included and the Code wording has been revised to make this clearer: "When, in the opinion of the board, a significant proportion of ~~shareholders~~ <u>votes have been cast against</u> ~~have opposed~~ a resolution at any general meeting, the company should explain when announcing the results of voting what actions it intends to take to understand the reasons behind the vote result."

The FRC's intention is to change behaviour so that companies explain how they intend to engage with shareholders in order to assess their concerns (rather than setting out how they intend to respond to those concerns). The FRC continues to expect, as a number of respondents commented, that engagement by investors ahead of the meeting remains a key requirement of good stewardship.

Finally, there have been some minor amendments to other parts of Section E.2 to reflect the fact that it applies to general meetings rather than purely AGMs.

A majority of respondents supported the changes to Schedule A. To give Schedule A more clarity, in response to comments, the text has been spilt into three new sections – Balance, Share-based remuneration schemes, and Pensions. There has been a change made to the first paragraph to add in the wording underlined "The remuneration committee should determine an appropriate balance between fixed and performance-related, immediate and deferred remuneration" which it was felt better covered all types of remuneration.

Paragraphs four and five have been merged and the second sentence of paragraph five has been deleted as it is repetitive. The start of paragraph four has also been amended to say "For share-based remuneration..." and the phrase "of an option" removed to improve clarity. Some respondents felt that the original wording appeared to limit the consideration of shareholding requirements to being imposed in relation to shares acquired following the vesting and exercise of options only, and not to other forms of share-based variable remuneration.

Risk Management and Going Concern

This part of the consultation reflected feedback from the November 2013 consultation paper. The key remaining issue for decision was to establish the appropriate relationship between the board's risk assessment and management responsibilities, its assessment of the company's future viability and its ability to continue to adopt the going concern basis of accounting, and how these matters should be reported.

The FRC proposed that companies make two separate statements: one relating to an accounting basis assessment and another relating to a broader assessment of viability over time. The proposed statements would cover the matters to be considered when making the assessments and the time horizons and degree of certainty that can be attached to each. The aim was to encourage companies to provide meaningful disclosure tailored to the specific circumstances of the company.

This section of the consultation provoked the most comments and disagreement between respondents. Overall, however, there was recognition and acceptance of what the FRC was trying to achieve amongst the majority, in particular on the proposal for two separate statements. For those who retained opposing positions in principle to the FRC's proposed approach, disagreement centred around the detailed drafting of proposed Code revisions (provisions C.1.3, C.2.1 and C.2.2) and/or their positioning within the Code. Some respondents wished to continue to have a single statement about viability, but there was a substantial degree of disagreement about what this statement should cover. Some were keen that a single statement be restricted to an assessment of viability for accounting basis purposes, while some investors wanted a single statement to cover both short and longer term viability with a high standard of assurance.

Some of the suggestions for redrafting had merit individually, but in the context of maintaining the overall balance of the proposals, the FRC has decided to keep the wording of the statements as proposed. In response to comments about the repositioning of the statements, the FRC's assessment was that the discreet placement of the statements emphasises the importance of both financial and business reporting and risk management and internal control. The statements will therefore remain in their current positions.

Location of Corporate Governance Disclosures

Amongst issuers and audit firms there was support for improving annual reports and to moving corporate governance disclosures online. However, a significant number of investors and their representative bodies argued that removing such disclosures could be harmful. Given there was no clear steer the FRC will continue to keep this under review as part of the Financial Reporting Lab's long-term project looking at how companies are, and may use digital media to report externally to investors.

Respondents provided a number of suggestions about which disclosure requirements in the Code could be removed. There was, however, no consistent feedback and the FRC has decided to reconsider this matter before the next consultation on the Code in 2016.

Other issues

Two further issues arose as a result of the consultation and wider stakeholder engagement.

Diversity and Board Dialogue

The FRC has also given consideration to how board effectiveness might be enhanced through achieving a dialogue which is both more challenging and constructive. This is in part related to issues of diverse board composition. Lord Davies' fourth and final annual progress report on the attainment of the target of 25% women on FTSE100 boards will be published in 2015. We will consider how this opportunity might be used to inform our 2016 Code consultation. The preface to the new Code includes reference to the value which should be attached to board diversity in its broadest sense, including diversity of approach and experience.

Board Culture

The preface has been refreshed in part to reflect developments in corporate governance. We have added language emphasising the importance of the board in establishing the correct 'tone from the top'. The board should set standards and the directors should act in accordance with those standards in order to encourage good governance throughout the organisation. This will help prevent misconduct, unethical practices and support the delivery of long-term success.

Guidance on Risk Management and Internal Control and Related Financial and Business Reporting

The 'Guidance on Risk Management, Internal Control and Related Financial and Business Reporting' ("the Guidance") has been amended in light of consultations the FRC undertook in November 2013 and April 2014. It is an amalgamation of the 2005 'Internal Control: Guidance to Directors' (formally known as the Turnbull Guidance) and the 2009 'Going Concern and Liquidity Risk: Guidance for Directors of UK Companies' papers. This new Guidance will be kept under review.

In response to the November 2013 consultation, chapters and appendices of the Guidance have been consolidated and reordered. The section on the determination of principal risks has been moved into Section 4: 'Establishing the Risk Management and Internal Control Systems'. This placement more strongly reinforces the key nature of this assessment to the risk management and internal control systems. The Appendix included in the November 2013 consultation covering warning signs has been removed to reduce duplication. However a number of the warning signs have been included in Appendix C, 'Questions for the Board to Consider'.

Amendments to the wording were also made in response to concerns received in the November 2013 consultation. These included ensuring better consistency of language use; clarification of the wording around those activities for which the FRC expects the board to be responsible, as opposed to those that may be undertaken by management; and clearer information about elements of the overall risk management and internal control systems and how the board should go about determining those risks that are principal risks for the company.

The April 2014 consultation on the Code also included relevant questions on two appendices to the risk management guidance relating to the going concern statement and the longer-term viability statement. In light of responses to this consultation, minor wording changes have been made to the appendices on the ‘Going Concern Basis of Accounting and Material Uncertainties’ and the ‘Longer-term Viability Statement’. The original ‘Guidance on Reporting’ has been incorporated into the main section of the Guidance. The FRC has also made the decision to retain the requirement for companies to report on actions being taken to address significant failings or weaknesses and, in reaction to consultation responses, has included guidance on the reporting of these failings or weaknesses as described in the consultation document.

APPENDIX

Summary of the differences between the 2012 and 2014 editions of the Code

2012 Edition	2014 Edition
Preface	Wording specific to the 2012 edition and preceding review of the Code has been removed and the overall section revised.
The Main Principles of the Code	Updated wording to reflect the relevant changes made to the main principle wording in Sections D and E.
Provision 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.	*Underlined wording has been added:* 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 <u>position and</u> performance, business model and strategy. There should be a statement by the auditor about their reporting responsibilities.
Provision C.1.3: The directors should report in annual and half-yearly financial statements that the business is a going concern, with supporting assumptions or qualifications as necessary.	*Underlined wording has been added with deletions shown as strikethroughs:* ~~The directors should report in annual and half-yearly financial statements that the business is a going concern, with supporting assumptions or qualifications as necessary.~~ <u>In annual and half-yearly financial statements, the directors should state whether they considered it appropriate to adopt the going concern basis of accounting in preparing them, and 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.</u>
Principle C.2: The board is responsible for determining the nature and extent of the significant risks it is willing to take in achieving its strategic objectives. The board should maintain sound risk management and internal control systems.	*Underlined wording has been added with deletions shown as strikethroughs:* The board is responsible for determining the nature and extent of the ~~significant~~ <u>principal</u> risks it is willing to take in achieving its strategic objectives. The board should maintain sound risk management and internal control systems.

Provision C.2.1: The board should, at least annually, conduct a review of the effectiveness of the company's risk management and internal control systems and should report to shareholders that they have done so. The review should cover all material controls, including financial, operational and compliance controls.	*Underlined wording has been added with deletions shown as strikethroughs:* <u>Provision C.2.1</u> <u>The directors should confirm in the annual report that 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. The directors should describe those risks and explain how they are being managed or mitigated.</u> <u>Provision C.2.2</u> <u>Taking account of the company's current position and principal risks, the directors should explain in the annual report how they have assessed the prospects of the company, over what period they have done so and why they consider that period to be appropriate. The directors should 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.</u> <u>Provision C.2.3</u>~~1~~ The board should <u>monitor the company's risk management and internal control systems and</u>, at least annually, ~~conduct~~ <u>carry out</u> a review of their effectiveness ~~of the company's risk management and internal control systems~~, <u>and</u> ~~should~~ report ~~to shareholders~~ on that review in the annual report. ~~they have done so~~ The <u>monitoring and</u> review should cover all material controls, including financial, operational and compliance controls.

Provision C.3.4: Where requested by the board, the audit committee should provide advice on whether 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.	*Underlined wording has been added to match the change to C.1.1:* Where requested by the board, the audit committee should provide advice on whether 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 position and performance, business model and strategy.
Principle D.1: Levels of remuneration should be sufficient to attract, retain and motivate directors of the quality required to run the company successfully, but a company should avoid paying more than is necessary for this purpose. A significant proportion of executive directors’ remuneration should be structured so as to link rewards to corporate and individual performance. Supporting Principles The performance-related elements of executive directors’ remuneration should be stretching and designed to promote the long-term success of the company. The remuneration committee should judge where to position their company relative to other companies. But they should use such comparisons with caution, in view of the risk of an upward ratchet of remuneration levels with no corresponding improvement in performance. They should also be sensitive to pay and employment conditions elsewhere in the group, especially when determining annual salary increases.	*Underlined wording has been added with deletions shown as strikethroughs:* ~~Levels of remuneration should be sufficient to attract, retain and motivate directors of the quality required to run the company successfully, but a company should avoid paying more than is necessary for this purpose. A significant proportion of executive directors’ remuneration should be structured so as to link rewards to corporate and individual performance.~~ 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. Supporting Principles ~~The performance-related elements of executive directors’ remuneration should be stretching and designed to promote the long-term success of the company.~~ The remuneration committee should judge where to position their company relative to other companies. But they should use such comparisons with caution, in view of the risk of an upward ratchet of remuneration levels with no corresponding improvement in corporate and individual performance, and should avoid paying more than is necessary. They should also be sensitive to pay and employment conditions elsewhere in the group, especially when determining annual salary increases.

Provision D.1.1 In designing schemes of performance-related remuneration for executive directors, the remuneration committee should follow the provisions in Schedule A to this Code.	*Underlined wording has been added with deletions shown as strikethroughs:* In designing schemes of performance-related remuneration for executive directors, the remuneration committee should follow the provisions in Schedule A to this Code. <u>Schemes 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</u>.
Principle D.2: Supporting Principles The remuneration committee should consult the chairman and/or chief executive about their proposals relating to the remuneration of other executive directors. The remuneration committee should be responsible for appointing any consultants in respect of executive director remuneration. Where executive directors or senior management are involved in advising or supporting the remuneration committee, care should be taken to recognise and avoid conflicts of interest. The chairman of the board should ensure that the company maintains contact as required with its principal shareholders about remuneration.	*Underlined wording has been added with deletions shown as strikethroughs:* Supporting Principles ~~The remuneration committee should consult the chairman and/or chief executive about their proposals relating to the remuneration of other executive directors.~~ <u>The remuneration committee should 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</u>. The remuneration committee should also be responsible for appointing any consultants in respect of executive director remuneration. ~~Where executive directors or senior management are involved in advising or supporting the remuneration committee, care should be taken to recognise and avoid conflicts of interest.~~ The chairman of the board should ensure that the ~~company~~ <u>committee chairman</u> maintains contact as required with its principal shareholders about remuneration.
Principle E.2	*Reference to "AGM" in the title and main principle replaced by "general meetings".*
Provision E.2.2: The company should ensure that all valid proxy appointments received for general meetings are properly recorded and counted. For each resolution, where a vote has been taken on a show of hands, the company should ensure that the following information is given at the meeting and made available as soon as reasonably	*Underlined wording has been added:* Provision E.2.2: The company should ensure that all valid proxy appointments received for general meetings are properly recorded and counted. For each resolution, where a vote has been taken on a show of hands, the company should ensure that the following

practicable on a website which is maintained by or on behalf of the company: • the number of shares in respect of which proxy appointments have been validly made; • the number of votes for the resolution; • the number of votes against the resolution; and • the number of shares in respect of which the vote was directed to be withheld.	information is given at the meeting and made available as soon as reasonably practicable on a website which is maintained by or on behalf of the company: • the number of shares in respect of which proxy appointments have been validly made; • the number of votes for the resolution; • the number of votes against the resolution; and • the number of shares in respect of which the vote was directed to be withheld. When, in the opinion of the board, a significant proportion of votes have been cast against a resolution at any general meeting, the company should explain when announcing the results of voting what actions it intends to take to understand the reasons behind the vote result.
Provision E.2.4: The company should arrange for the Notice of the AGM and related papers to be sent to shareholders at least 20 working days before the meeting.	*Underlined wording has been added:* The company should arrange for the Notice of the AGM and related papers to be sent to shareholders at least 20 working days before the meeting. For other general meetings this should be at least 14 working days in advance.
Schedule A: The remuneration committee should consider whether the directors should be eligible for annual bonuses. If so, performance conditions should be relevant, stretching and designed to promote the long-term success of the company. Upper limits should be set and disclosed. There may be a case for part payment in shares to be held for a significant period. The remuneration committee should consider whether the directors should be eligible for benefits under long-term incentive schemes. Traditional share option schemes should be weighed against other kinds of long-term incentive scheme. Executive share options should not be offered at a discount save as permitted by the relevant provisions of the Listing Rules.	*Underlined wording has been added with deletions shown as strikethroughs:* Balance The remuneration committee should determine an appropriate balance between fixed and performance-related, immediate and deferred remuneration. ~~consider whether the directors should be eligible for annual bonuses. If so,~~ Performance conditions, including non-financial metrics where appropriate, should be relevant, stretching and designed to promote the long-term success of the company. Remuneration incentives should be compatible with risk policies and systems. Upper limits should be set and disclosed.

In normal circumstances, shares granted or other forms of deferred remuneration should not vest, and options should not be exercisable, in less than three years. Directors should be encouraged to hold their shares for a further period after vesting or exercise, subject to the need to finance any costs of acquisition and associated tax liabilities. Any new long-term incentive schemes which are proposed should be approved by shareholders and should preferably replace any existing schemes or, at least, form part of a well-considered overall plan incorporating existing schemes. The total rewards potentially available should not be excessive. Payouts or grants under all incentive schemes, including new grants under existing share option schemes, should be subject to challenging performance criteria reflecting the company's objectives, including non-financial performance metrics where appropriate. Remuneration incentives should be compatible with risk policies and systems. Grants under executive share option and other long-term incentive schemes should normally be phased rather than awarded in one large block. Consideration should be given to the use of provisions that permit the company to reclaim variable components in exceptional circumstances of misstatement or misconduct. In general, only basic salary should be pensionable. The remuneration committee should consider the pension consequences and associated costs to the company of basic salary increases and any other changes in pensionable remuneration, especially for directors close to retirement.	The remuneration committee should consider whether the directors should be eligible for annual bonuses and/or benefits under long-term incentive schemes. Share-based remuneration Traditional share option schemes should be weighed against other kinds of long-term incentive scheme. Executive share options should not be offered at a discount save as permitted by the relevant provisions of the Listing Rules. Any new long-term incentive schemes which are proposed should be approved by shareholders and should preferably replace any existing schemes or, at least, form part of a well-considered overall plan incorporating existing schemes. The total rewards potentially available should not be excessive. For share-based remuneration the remuneration committee should consider requiring directors ~~should be encouraged~~ to hold a minimum number of ~~their~~ shares and to hold shares for a further period after vesting or exercise, including for a period after leaving the company, subject to the need to finance any costs of acquisition and associated tax liabilities. In normal circumstances, shares granted or other forms of deferred remuneration should not vest or be paid, and options should not be exercisable, in less than three years. Longer periods may be appropriate. Grants under executive share option and other long-term incentive schemes should normally be phased rather than awarded in one large block. ~~There may be a case for part payment in shares to be held for a significant period.~~ ~~Payouts or grants under all incentive schemes, including new grants under existing share option schemes, should be subject to challenging performance criteria reflecting the company's objectives, including non-financial performance metrics where appropriate. Remuneration incentives should be compatible with risk policies and systems.~~

	~~Consideration should be given to the use of provisions that permit the company to reclaim variable components in exceptional circumstances of misstatement or misconduct.~~ Pensions In general, only basic salary should be pensionable. The remuneration committee should consider the pension consequences and associated costs to the company of basic salary increases and any other changes in pensionable remuneration, especially for directors close to retirement.

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