



## Governance in Brief

### Your summary of the latest corporate governance developments

#### Headlines

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**In Brief:** The Financial Reporting Council (FRC) has published an analysis of how the two codes under its supervision are being implemented – the UK Corporate Governance Code for listed companies, revised in 2010, and the UK Stewardship Code for investors, launched in the same year.

The report reveals a good level of take up of the new provisions of the UK Corporate Governance Code announced last year and that over 230 asset managers, asset owners and service providers have signed up to the Stewardship Code in its first year, including most of the major investors in UK equities. The FRC believes this is a solid platform on which further progress should be made in the coming year.

Whilst the FRC welcomes the efforts being made by many companies to provide real insight into their governance arrangements, it has observed some poor practice in reporting and believes there is need for continued improvement. The following areas have been highlighted in particular:

**Explanations** – for the ‘comply or explain’ approach to be seen as credible it is essential that, where companies choose not to follow the UK Corporate Governance Code, they set out clearly the reasons for their decisions so that shareholders can reach a view about whether the arrangements the company has put in place protect their interests. The FRC is currently holding discussions with companies and investors with the aim of identifying common criteria that companies can refer to when preparing their corporate governance statements.

*In the meantime, our recommendation is that an explanation should make it clear how the company continues to meet the spirit of the relevant main or supporting principle of the Code despite the particular non-compliance. It is not acceptable to include just a statement of fact that a Code provision has not been complied with.*

**The chairman’s statement** – in the preface to the UK Corporate Governance Code, the FRC suggested that company chairmen make a personal statement on how they have applied the Code’s principles on the role and effectiveness of the board. A substantial number of chairmen have responded to this challenge and made a real effort to explain the thinking behind, for example, the composition of the board or the main decisions taken during the year. The FRC encourages other companies to follow these examples.

*Section 9 of the Deloitte publication “Gems and jetsam – surveying annual reports” sets out some good practice examples of such statements.*

**Board room diversity** – in October 2011 the FRC announced changes to the UK Corporate Governance Code to require companies to disclose their policy on boardroom diversity, including gender, and to report annually on how it is being implemented. These changes will not come into effect until periods commencing on or after 1 October 2012, but the FRC strongly encourages early adoption.

*Further details of these changes were set out in the October edition of Governance in brief.*

**Board evaluation** – the FRC has observed that information about the board evaluation review process and outcomes is only provided by a minority of companies, but is more widespread than in previous years. It is therefore keeping disclosures on board evaluation under review. In addition, the FRC considers that information on the identity of external advisers used in the process should be provided as a matter of course, as it is for other external advisers.

*We recommend that companies should make it clear how the board performance evaluation was carried out, when it was last carried out, by whom (i.e. was it an internal process or was it externally facilitated), what were the outcomes and what plans are in place to address these.*

**Business model** – in this section of its report the FRC quotes from the Deloitte publication “Gems and jetsam” on our findings on disclosures of the business model: “an area where detailed requirements have not been laid down is allowing companies the freedom to develop their own interpretations of the disclosure”. The FRC agrees that companies will need to experiment and innovate to discover how best to convey their business models in a way that resonates with readers.

*Section 6 of “Gems and jetsam” includes a number of different examples of business model disclosures.*

**Strategy and risk** – while recognising the improvement that has already been made the FRC believes that this is an area where more effort is still needed. Specifically, the FRC believes that reporting should focus on strategic risks and the major operational risks inherent in their business models and strategies, rather than generic risks applicable to all companies.

*Section 7 of “Gems and jetsam” discusses risk disclosures and provides some good practice examples where companies have linked strategy and risk disclosures effectively.*

**Audit committees** – the FRC identifies the issue that although many audit committees disclose their role and responsibilities, the actual activities undertaken to discharge those responsibilities are rarely covered. In addition, the FRC states that very few audit committees report the key decisions taken or judgements made by the audit committee. The FRC believes this threatens to undermine confidence in audit committees.

*This view is consistent with the findings of our annual reporting survey. Section 10 of “Gems and jetsam” sets out the audit committee reports of Barclays and Pearson in full as we believe that these are best practice examples. They include a description of the key issues discussed by the audit committee and the auditors during the year.*

**Remuneration committees** – the FRC reports that relatively few of the sample of remuneration committee reports it reviewed provided much insight into the reasons why the committee made the decisions that it did. Specifically, the link between remuneration policy and the company’s strategy and approach to risk is rarely described clearly. The FRC states that “in the current climate, companies need to be more transparent about these issues”.

In relation to the Stewardship Code the FRC says that there are some big challenges, one of which it refers to as the “pig in the python” problem. This is the fact that so much of engagement activity is concentrated into the few months between companies’ annual reports and annual general meetings, most of which take place at the same time of year. There is a need to address this problem through on-going engagement at other times of the year.

Limited changes can be expected to both codes and these will take effect from 1 October 2012. Consultations on these amendments and to the related supporting guidance can be expected during 2012. The FRC does state that the aim will be then to leave both codes unchanged to a further two years.

**Date:** 14 December 2011

**Source:** The Financial Reporting Council

**Further info:** <http://www.frc.org.uk/press/pub2671.html>

“Gems and jetsam – surveying annual reports” is available from the audit section of [www.deloitte.co.uk](http://www.deloitte.co.uk)

### **Time to take action**

- Review the areas of focus for reporting detailed above when preparing your annual report, there is plenty of scope to make necessary improvements in this reporting season.
- Consider the FRC's comments about "the pig in the python" and ensure that shareholder engagement is not focused just in one part of the year.

### **On the horizon**

- Further announcements from BIS in the early part of 2012 on the next steps to put proposed audit exemptions in place.
- Legislative proposals from the EC further to the Green Paper on corporate governance.
- Consultations on limited changes to the UK Corporate Governance Code in the areas of diversity, audit committees, internal control and risk management and going concern and the related guidance documents plus limited changes to the Stewardship Code. Final documents are likely to be issued in the summer with an effective date of 1 October 2012. There will then be a two year moratorium on changes.

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