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July 2018

Governance *in brief*

FRC issues new UK Corporate Governance Code

Headlines

- The FRC has published the new UK Corporate Governance Code together with revised Guidance on Board Effectiveness. The new Code applies for periods commencing on or after 1 January 2019.

- The changes introduced are far reaching in some areas, and reflect the Prime Minister's broad social reform agenda and desire to restore trust in UK business.

- New Code **principles** on:
  - alignment of company purpose, strategy, values and corporate culture;
  - effective engagement with shareholders and stakeholders;
  - responsibilities of the board to ensure that workforce policies and practices are consistent with the company's values and support its long-term sustainable success;
  - consideration of the length of service of the board as a whole and the need for regular board refreshment; and
  - alignment of remuneration and workforce policies to the long-term success of the company and its values.

- New Code **provisions** on:
  - the board's role in monitoring and assessing culture;
  - mechanisms for gathering the views of the workforce;
  - reporting on how stakeholder interests, and the other matters set out in section 172, have influenced the board's decision-making;

- – succession planning and board member contribution;
- – diversity and inclusion;
- – the length of tenure of the chair;
- – board responsibility for identifying and assessing emerging risks (in addition to the principal risks);
- – holding periods for long-term incentive schemes; and
- – pension arrangements.

- This is not a tweaking of the Code as in previous years but a substantial re-write and simplification/reduction with the idea at its foundation that the focus of the revised Code is the company's approach to governance through the application of the Code principles – principles which emphasise the value of good corporate governance to long-term success.
- There is much to address and boards will wish to engage early with the new Code. Leading companies may wish to demonstrate progress by early adoption and reporting on some areas in their 2018 annual reports.
- In addition to the changes to the Code, investors are bringing their own pressures to bear and increasing focus on matters such as director competence, the impact of climate change and alignment of KPIs to the drivers of long term value creation.

Introduction

It is over 25 years since the UK Corporate Governance Code was first introduced in December 1992 and governance within the largest companies has been subject to heightened scrutiny from both the public and the government. Now the FRC has undertaken a comprehensive review to ensure that the Code remains fit for purpose and continues to promote improvement in the quality of governance.

The new Code includes a number of specific changes to the Code requested by the government's response to the Green Paper Consultation on Corporate Governance Reform. In addition, to achieve a wider stakeholder focus, the changes draw out the findings from the FRC's 2016 Culture Report. The changes have also taken account of the Hampton-Alexander Review and Parker Review reports on diversity.

Application of the UK Corporate Governance Code

The Listing Rules continue to require all Premium-listed companies to disclose how they have applied the principles of the Code in a manner that would enable shareholders to evaluate how these have been applied.

Over time, experience has shown that companies have focused on the 'comply or explain' aspects of the provisions rather than a description of their application of the principles. When reporting on the principles, the Code requires companies to demonstrate to shareholders why the board has implemented certain structures, policies and practices and how these aspects meet the relevant Code principle.

All provisions should be complied with or an explanation should be given. It should be noted that, as with the current Code, some provisions have specific reporting requirements.

The new Code has five sections:

1. Board leadership and company purpose
2. Division of responsibilities
3. Composition, succession and evaluation
4. Audit, risk and internal control
5. Remuneration

How the FRC has responded to the consultation process

The FRC received more than 270 responses to the consultation. We set out here the key elements the FRC has changed to address concerns raised in those responses.

Workforce engagement mechanisms	There is now clarity that any, or a combination of, the three workforce engagement mechanisms can be used, but if a company is not using one of the stated mechanisms then it must provide a description of the mechanism it is using and why that mechanism is effective.
Independence	Unlike the draft proposed for consultation, the final version of the new Code has reverted back to the chairman just needing to be independent on appointment. In addition, the proposed hardening of the provision on independence of non-executive directors has been reduced to a requirement to provide a clear explanation where a decision is taken to state that a non-executive director is independent notwithstanding any of the circumstances which might impair, or appear to impair, independence existing. A new provision on the tenure of the chair has been introduced which states that the tenure should not be more than nine years since joining the board. In order to facilitate effective succession planning this period can be extended for a limited time with a clear explanation.
Internal audit	Where there is no internal audit function, the audit committee must explain how internal assurance is achieved and also the impact on external audit.
Risk	On risk, there is a new requirement for boards to carry out a robust assessment of “emerging risks”, in addition to the principal risks, and also to ensure that there are procedures in place to identify emerging risks.
Remit of the Remuneration Committee	The remit of the Remuneration Committee has been clarified as including the review (rather than oversight) of workforce remuneration and related policies and alignment with culture, and the need to take these matters into account when setting the policy for executive director remuneration.
Exemptions for smaller companies	In response to feedback, three of the four smaller company exemptions (for companies outside FTSE 350) have been reinserted. These include the exemption on Audit Committee and Remuneration Committee composition and the requirement for external facilitation of the board performance review once every three years. This means that the only exemption which has been removed is the annual re-election of directors. Companies outside the FTSE 350 will need to make arrangements for annual re-election of their directors if they are not already doing so.

Additions and changes to the UK Corporate Governance Code

In the section below we review each of the sections of the new Code and draw out the key features which have been added to the principles and provisions and we also explain where there have been changes to the existing Code principles or provisions:

Board leadership & company purpose

This is the section of the revised Code with the most changes, both in the principles and the provisions.

Key new features in the principles

- The board should promote the **long-term sustainable success** of the company, generating **value for shareholders** and **contributing to wider society**.
- The board should establish the **company's purpose, values and strategy** and satisfy itself that these and its culture are **aligned**.
- All directors must **act with integrity, lead by example** and **promote the desired culture**.
- The board should ensure **effective engagement** with, and encourage participation from, the workforce and other stakeholders.
- The board should ensure that **workforce policies and practices** are **consistent with the company's values** and support its **long-term sustainable success**.
- The workforce should be able to **raise any matters of concern**.

Key new features in the provisions

- The annual report should include a description of how opportunities and risks to the **future success and sustainability of the business model** have been considered and addressed.
- It should be clear how the company's **governance arrangements** contribute to the **delivery of its strategy**.
- The board should **assess and monitor the culture** to satisfy itself that policies, practices and behaviour throughout the business are **aligned with the company's purpose, values and strategy** and seek assurance that management is taking corrective action where there is **misalignment** (activities and any actions taken in this regard should be described in the annual report).
- The annual report should include an explanation of the company's approach to investing in and rewarding its workforce.
- The board should understand the views of other stakeholders and describe in the annual report how their interests and the matters set out in section 172 of the Companies Act 2006 have been considered in board discussions and **influenced the board's decision-making**.
- For engagement with the workforce **one or a combination** of the following methods should be used: a director appointed from the workforce, a formal workforce advisory panel or a designated non-executive director.
- The board should take action to identify and manage **conflicts of interest**.

Changes made to existing Code principles and provisions

Whistleblowing – this part of the Code has been re-focused. It is no longer restricted to financial improprieties and is, therefore, no longer restricted to an audit committee activity. It becomes a board responsibility to establish mechanisms for the workforce to raise concerns together with proportionate and independent investigation of such matters and follow-up action.

Significant votes against a resolution – the existing Code provision has been amended to specify that explanation is required where **20% or more** of votes have been cast against a resolution, rather than the current reference to "a significant proportion", reflecting the threshold for registration of significant votes against being maintained by the Investment Association.

Division of responsibilities

Key new feature in the principles

- The chair should demonstrate **objective judgement** throughout their tenure.

- Non-executive directors should have **sufficient time** to meet their board responsibilities.

Key new features in the provisions

- Non-executive directors have a prime role in **appointing and removing** executive directors.

- When making new appointments, the board should take into account **other demands** on directors' time. Prior to appointment, **significant commitments** should be disclosed with an indication of the time involved.

- Non-executive directors should **scrutinise and hold to account** the performance of management and individual executive directors against agreed performance objectives.

Changes made to existing Code principles and provisions

Independence – there is a change of emphasis in the Code provision on non-executive director independence. In the existing Code, indicators are presented but the board retains an option to decide that a director is independent notwithstanding the existence of one or more of those indicators. Under the new Code, this remains the case but there is a more direct requirement to provide a clear explanation where any of the circumstances apply and the board nonetheless considers the non-executive director is independent.

Development and induction – principles and provisions in the existing Code on board development and induction have been removed and are covered in the revised Guidance on Board Effectiveness.

Composition, succession and evaluation

Key new features in the principles

- Consideration should be given to the length of service of the board as a whole and board membership should be **regularly refreshed**.
- Board appointments to **promote diversity** of gender, social and ethnic backgrounds, cognitive and personal strengths.

Key new features in the provisions

- The nomination committee should ensure plans are in place for **orderly succession to the board** and senior management positions and oversee the development of a **diverse pipeline** for succession.
- Papers accompanying the resolutions to elect each director should set out the **specific reasons** why their **contribution** is, and continues to be, important to the company's long-term sustainable success.
- The chair should not remain in post **beyond nine years** from the date of their first appointment to the board. To facilitate **effective succession planning** and the **development of a diverse board**, this period can be extended for a limited time, particularly in those cases where the chair was an existing non-executive director on appointment. A **clear explanation** should be provided.
- Each director should engage with the evaluation process and take **appropriate action** when **development needs** have been identified.
- The annual report should explain the policy on **diversity and inclusion**, its objectives and linkage to company strategy, how it has been implemented and **progress on achieving the objectives**.
- The annual report should identify the gender balance of those in the senior management and their direct reports.

Changes made to existing Code principles and provisions

Annual re-election of directors – the existing exemptions for companies outside the FTSE 350 in relation to annual re-election of directors has been removed, meaning that all sizes of premium listed company would need to 'comply or explain' with this Provision of the Code.

Board evaluation – the existing Code provision asking companies to describe how the board evaluation has been conducted has been supplemented in the updated Code by a call for a description of the outcomes, actions taken, how the evaluation has influenced board composition and the nature and extent of an external evaluator's contact with the board and individual directors.

Audit, risk and internal control

Key new features in the principles

- The board should establish formal and transparent policies and procedures to ensure the **independence and effectiveness of internal and external audit functions**.
- The board should satisfy itself on the **integrity of financial information**.
- The board should satisfy itself that the company's **internal controls are robust**, and allow for **prudent and effective risk assessment and management**.

Key new features in the provisions

- Where there is no internal audit function, there should be an explanation for the absence, how **internal assurance** is achieved, and how this affects the work of external audit.
- The board should carry out a robust assessment of the company's **emerging risks** (in addition to the principal risks) and provide a description of the **procedures** in place to identify emerging risks.

Remuneration

Key new features in the principles

- Remuneration policies and practices should be designed to **support strategy** and **promote long-term sustainable success**.
- Executive remuneration should be **aligned to company purpose** and **values**, and be clearly linked to the **successful delivery of the company's long-term strategy**.
- A formal and transparent procedure should be established in order to **develop policy on executive remuneration** and to **determine the remuneration of senior management** (defined as the executive committee or the first layer of management below board level, including the company secretary), as well as board directors.
- Directors should exercise **independent judgement and discretion** when authorising remuneration outcomes, taking account of company and individual performance, and wider circumstances.

Key new features in the provisions

- Before appointment as chair of the remuneration committee, the appointee should have served on a remuneration committee for **at least twelve months**. The minimum number of independent non-executive directors on the committee is three, two **for smaller companies**.
- **Independent judgement** should be exercised when evaluating the advice of external third parties and when receiving views from executive and senior management. Any connection between the remuneration consultant and the company or individual directors should be identified in the annual report.
- Remuneration schemes should **promote long-term shareholdings** by executive directors that support alignment with long-term shareholder interests.
- In normal circumstances, share awards granted should be released for a sale on a phased basis and be subject to a total vesting and holding period of **five years or more**.

- The remuneration committee should develop a formal policy for **post-employment shareholding** requirements encompassing both **unvested** and **vested** shares.
- Remuneration schemes and policies should enable the use of **discretion to override formulaic outcomes**.
- When determining executive director remuneration policy and practices, the remuneration committee should address a number of factors. These include: clarity; simplicity; identification and mitigation of potential reputational, behavioural or other risks; the range of potential outcomes; a demonstrable link between individual awards and long term performance; and alignment to culture (including driving behaviours consistent with company culture and strategy and in the context of the workforce as a whole).
- The annual report should include:
  - an explanation of the strategic rationale for senior executive remuneration policies, structures and any performance metrics
  - reasons why the remuneration is appropriate based on internal and external measures, including pay ratios and pay gaps
  - whether the policy operated as intended in terms of company performance and quantum and, if not, what changes are necessary
  - what engagement has taken place with shareholders and the impact this has had on remuneration policy and outcomes
  - what engagement with the workforce has taken place to explain how executive remuneration aligns with wider company pay policy
  - the impact of any board discretion on remuneration outcomes

Changes made to existing Code principles and provisions

Senior management pay – under the existing Code, the remuneration committee should 'recommend and monitor' the level and structure of remuneration for senior management. This has been strengthened to give the remuneration committee responsibility for **setting remuneration for senior management**.

Workforce policies and practices – the existing Code requires remuneration committees to be 'sensitive to pay and employment conditions elsewhere in the group.' The revised Code places greater emphasis on the role of the remuneration committee, which should now review workforce remuneration and related policies and the alignment of incentives and rewards with culture, **taking these into account when setting the policy for executive director remuneration**.

Pensions – there is now a specific provision relating to pension arrangements, previously included in Schedule A. This emphasises the need to take into account the pension consequences of salary increases, along with any other changes in pensionable remuneration or contribution rates and also now includes a reference to these being **aligned to pension arrangements for the workforce** as a whole.

FRC monitoring activity on the revised Code

The Feedback Statement issued with the revised Code makes it clear that the FRC is planning to monitor how governance practices and reporting develop in response to the new Code and will be doing more in-depth reviews of annual reports to engage with companies on their reporting against the new Code.

In addition, the FRC will be embarking on an outreach programme to aid understanding of the new Code by investors and proxy voting agencies and to support its implementation by companies and their advisors.

Revised Guidance on Board Effectiveness

The revised Guidance on Board Effectiveness is considerably longer and includes new commentary on areas such as culture, relations with the workforce and wider shareholders and diversity. It also incorporates new sections on the workings of board committees, notably the remuneration committee. Helpfully, the Guidance includes questions for boards to ask themselves or, in some cases, to ask management, about effectiveness in key areas.

The Guidance has been structured to reflect the new Code and some notable changes to the previous version include:

Board leadership and company purpose	This section covers the nature of the effective board, its focus on generating and preserving value for shareholders for the long-term whilst taking account of the interests of the workforce and the impact on other stakeholders (s172), its focus on values, behaviours and culture, the importance of diversity and avoiding "group think", and achieving high-quality decision making. It covers relations with shareholders, with the workforce and with wider stakeholders, including examples of workforce engagement activities that some companies use to achieve meaningful, regular two-way dialogue. It also incorporates certain results and thinking from the FRC's Culture initiative as previously published in Culture and the Role of Boards (2016).
Division of responsibilities	This section focuses on clarifying and delineating the roles of board members including the chair, senior independent director, executive and non-executive directors, and board support functions, such as the company secretary/secretariat.
Composition, succession and evaluation	This section covers the role of the nomination committee and substantially expands upon the previous Guidance on Board Effectiveness by increasing the focus on values, behaviours and the balance of skills, experience, knowledge and diversity on the board. It incorporates a new call for chairs and non-executive directors to understand and commit to the time that is and may be required in their role. It also discusses methods of improving diversity and inspiring diversity throughout the workforce through mentoring and sponsorship schemes and positive action. The section on succession proposes that boards should discuss tenure at the time of appointment to help inform and manage the long-term succession strategy and again encourages looking at succession as an opportunity to motivate employees throughout the organisation. On board evaluation, there is a new call for boards to obtain input from the workforce and other stakeholders on the board's performance.
Audit, risk and internal control	This short section covers the role of the audit committee and reiterates some key points also in the Guidance on Audit Committees. It also highlights the FRC's focus on viability statements, in particular the two stage process of first considering and reporting on longer term prospects and then providing the statement on viability over the period of the board's assessment.
Remuneration	This is the first time the FRC has provided guidance outside the Code on the role of the remuneration committee in particular. The Guidance suggests that boards can choose to delegate responsibility for overseeing wider workforce remuneration, incentives and workforce policies to the remuneration committee, or, where appropriate, another committee with relevant responsibilities. It calls for an integrated approach that joins up consideration of wider workforce pay and policies with the consideration of executive remuneration, and proposes that the remuneration committee should engage with the workforce to explain how executive remuneration aligns with wider company pay policy and promotes long term value generation.

Timing

The new Code is applicable to all companies with a premium listing of equity shares for **periods commencing on or after 1 January 2019**.

The FRC has also announced that it plans to consult on specific changes to the Stewardship Code later in 2018.

For further information:

To access the new Code, please go to **https://www.frc.org.uk/news/july-2018/a-uk-corporate-governance-code-that-is-fit-for-the**

To explore in more detail the opportunities and challenges related to engaging with the workforce and other stakeholders, please click **here**.

Deloitte View

Governance reform

- The FRC has taken the opportunity to do a fundamental review and to modernise the Code. The proposed changes fit well with the other parts of the Government's governance reform package and the new reporting legislation which was issued in June.

Application of principles

- The emphasis on how companies have applied the principles is welcome and it is now up to companies to respond to support this more considered approach to corporate governance.

Purpose and stakeholder engagement

- Company purpose and stakeholder engagement take more central roles in the Code – and companies will need to ensure they address these areas with integrity, as they will be quickly exposed if their statements do not ring true to stakeholders.

Tenure of the board chair

- The stricter rule of the tenure of the board chair will present a challenge for some companies and will reinforce the need for effective succession planning.

Internal control and the role of internal audit

- We support the new requirement for the audit committee to explain how internal assurance is achieved in the absence of an internal audit function.

- We would encourage audit committees with an internal audit function to ensure that this critical third line of defence is appropriately resourced, well focused on principal risks and has appropriate and clear lines of accountability.

- The FRC has stopped short of board certification of internal financial controls, but reinforces the requirement for audit committees to pay close attention to the design and effectiveness of internal financial controls and the integrity of financial information.

Remuneration

- The new Code is in line with the direction of travel that many remuneration committees have been taking in recent years. The requirements, rightly, have a focus on alignment to long term sustainable value, and we welcome the new principle requiring committees to exercise judgement and discretion in respect of pay outcomes.

- A key new area is the extension of the remuneration committee remit to include reviewing workforce remuneration and related policies, including alignment of incentives and culture. To discharge these broader responsibilities effectively, companies will need to consider how relevant workforce data and context can be presented to remuneration committees in a comprehensive but practical way.

Smaller listed companies

- For premium listed companies outside the FTSE 350, although the implementation timetable proposed allows companies to make changes over the remainder of 2018, there is much to consider particularly when there are fewer resources available to take this on.

Investor pressures

- Board activities should not just be driven by these changes to the Code – investors are bringing their own pressures to bear and making clear that the creation of sustainable value over the longer term, taking into account business model transformation, is very important to them. Alignment of KPIs to the drivers of long term value creation is a key theme around remuneration as well as reporting to shareholders.

- Board consideration of (and response to) the potential impacts of climate change is a key area of focus for investors and legislators. Whilst there is at present mostly only voluntary frameworks and guidance published, we expect legislation to be coming forward soon. In advance of that, boards need to remember climate and societal impacts as they explain their activities to meet section 172.

- The whole area of director competence and whether directors have the time available to address an ever expanding set of responsibilities is also receiving much attention: investors want reassurance that the board is thinking carefully about board composition and succession; when things go wrong there is increased reputational contagion from company to company; and investors are looking carefully at the question of "overboarding".

- Finally, investors are keen to understand the impact of new accounting standards and areas of interpretation and the critical financial reporting judgements in reporting company performance.

Contact – Executive remuneration

Deloitte's executive remuneration practice helps clients develop executive remuneration strategies in line with corporate objectives and advises remuneration committees on the corporate governance and regulatory framework that applies to executive remuneration in the UK.

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