



# Contents

Introduction	<b>03</b>
Economic and political update	<b>06</b>
The nine big shifts – Moving from ‘doing digital’ to ‘being digital’	<b>09</b>
Leading the social enterprise – reinvent your company with purpose	<b>12</b>
Reporting on climate change	<b>16</b>
Diversity and inclusion	<b>22</b>
A new benchmark for stewardship – The 2020 Stewardship Code	<b>27</b>
Managing risk	<b>31</b>
Internal control and the board: What is all the fuss about?	<b>35</b>
Non-executive pay	<b>42</b>
The Section 172(1) Statement – Getting it right	<b>48</b>
Key messages for 2019/2020 reporting season annual reports	<b>50</b>
The new UK Corporate Governance Code – focusing on activities and outcomes	<b>56</b>
Taxation and state aid	<b>59</b>
Simplifying corporate structures	<b>62</b>
The reform agenda – a status report	<b>64</b>
Appendix	<b>68</b>

Economic and political update
Digital – the nine big shifts
The Social Enterprise
Reporting on climate change
Diversity and inclusion
The 2020 Stewardship Code
Managing risk
Internal control and the board
Non-executive pay
The Section 172(1) Statement
FRC reporting messages
Reporting on the 2018 Code
Taxation and state aid
Simplifying corporate structures
Audit market reform update
Appendix



# Introduction



Dear Board Member,

Our annual review is a full read, perhaps more than usual this year, as there is much to consider. In this year's review we continue with themes to highlight the challenges of delivering growth, geopolitical concerns, business model disruption, and technology transformation. All are key features of the day to day board agenda, as we also build trust in business. Now, at a time we see greater protectionism we are seeking to reshape our future trade and operating relationships with our trading partners.

In global markets, one of the trends that shows no sign of slowing is the move of investment capital from public markets – listed companies – to private markets. The Financial Times has described the growth of private capital as “the hottest trend in the global asset management industry”. This at a time when the responsibility and accountability of being a public company director is higher than ever.

Moving on to company reporting, in just a few months' time, early in 2020, your strategic report will include the new section 172 statement explaining the issues, factors and stakeholders you as directors considered relevant in fulfilling your duty, the engagement methods you used, and the resulting impact on your decisions and strategies during the financial year. This is a real opportunity for you to paint an authentic picture of the key messages in your business model, future strategies and your engagement with the company's ecosystem and the environment as well as your company's core values. There is both high interest in, and high expectations of, this important opportunity.

We start this year's review with articles focusing on economics, the nine big shifts for companies moving from a traditional IT operating model to an emerging digital strategy, and exploring how companies are responding to human capital trends by redesigning organisational behaviour and prioritising company purpose.

As we did last year, we have structured this year's 'On the board agenda' under key themes.

Economic and political update

Digital – the nine big shifts

The Social Enterprise

Reporting on climate change

Diversity and inclusion

The 2020 Stewardship Code

Managing risk

Internal control and the board

Non-executive pay

The Section 172(1) Statement

FRC reporting messages

Reporting on the 2018 Code

Taxation and state aid

Simplifying corporate structures

Audit market reform update

Appendix



### Responsible business

Here we consider the rising expectations from investors, regulators and others for more in-depth and informative reporting on climate change in annual reports as the UK moves towards a zero carbon economy by 2050. We also examine the potential reputational risks from failing to appropriately address diversity issues both within your board and your wider organisation.

### Risk & internal controls

Here we explore the challenges companies face in dealing with the new requirements to disclose procedures around emerging risks, and examine the dangers in our very human tendency to feel confident in our ability to manage risk, mentioning the substantial fines that are attracting attention to data protection in particular. We also examine the recent calls for a US style internal control attestation, which challenge whether the existing UK Corporate Governance Code goes far enough and whether there is sufficient guidance for boards and management, to execute their responsibility when they review the effectiveness of internal controls.

### Remuneration

We look at the expectations and the profile of the NED role and whether the increasing time commitments linked to changes in the business and governance expectations should be rewarded with increased remuneration.

### Year-end reporting & assurance update

The FRC's new leadership team has set out its areas of focus for the 2019/20 reporting season. We summarise these and highlight some of the new areas to watch out for in presenting your first section 172(1) statement and your first corporate governance report under the 2018 UK Corporate Governance Code.

Any questions for us, please do get in touch with your Deloitte partner or our governance team.

Yours faithfully,



**William Touche**

**Vice-Chair**

Leader of Deloitte UK Centre of Corporate Governance

November 2019

Economic and political update

Digital – the nine big shifts

The Social Enterprise

Reporting on climate change

Diversity and inclusion

The 2020 Stewardship Code

Managing risk

Internal control and the board

Non-executive pay

The Section 172(1) Statement

FRC reporting messages

Reporting on the 2018 Code

Taxation and state aid

Simplifying corporate structures

Audit market reform update

Appendix



# *Deloitte opinion pieces*

Economic and political update

Digital – the nine big shifts

The Social Enterprise

Reporting on climate change

Diversity and inclusion

The 2020 Stewardship Code

Managing risk

Internal control and the board

Non-executive pay

The Section 172(1) Statement

FRC reporting messages

Reporting on the 2018 Code

Taxation and state aid

Simplifying corporate structures

Audit market reform update

Appendix



# Economic and political update

A personal view and a note of caution from Ian Stewart, Deloitte's Chief Economist in the UK. To sign up to receive Ian's Monday Briefings, please click [here](#).

## Globalisation is getting more complex

US equities have hit new highs on hopes that China and the US would reach an agreement in their 18-month trade dispute. Financial markets think a deal would reduce uncertainty, boosting investment and growth. But a trade deal will not remove all tensions. Crucially, it is unlikely to address longstanding US complaints about intellectual property and China's interventionist industrial policy. And whatever the US and China agree, we are not going to return to the heyday of globalisation in the early 2000s.

This is partly because the global financial crisis had already dealt a major blow to globalisation. Trade was in the doldrums before the US-China trade dispute. Between 2012 and 2016 the volume of global trade grew by around 3% a year, less than half the average rate in the previous three decades.

Since the financial crisis a growing share of global trade has been subject to protectionist measures, creating new distortions in trade, many of them in the form of state subsidies for exports. Cross-border flows of capital, direct investment and lending have also slowed over the past decade.

Factors unrelated to protectionism have also weighed on trade. Companies increasingly need to control regulatory, reputational and political risk in their supply chains, which encourages companies to keep supply chains short, and production close to market. Rising wages in emerging markets, notably China, have eroded the savings from outsourcing. Such factors help explain why, after decades of job losses in US manufacturing, the sector has created a net 1.4m new jobs since 2009, the fastest growth since the 1960s.

Protectionism isn't just about tariffs and export subsidies. Nations have at their disposal a long list of tools to reduce imports, from restricting market access to foreign companies, blacklisting firms over security concerns and requiring local partners or ownership of foreign ventures.

Policymakers in China, the EU and the US routinely use these tools to prevent the offshoring of key sectors and to ensure security in areas such as telecoms and IT. (In the most recent examples, the US has banned the Chinese technology company Huawei from providing core equipment for America's 5G network and encouraged its allies to follow suit.)

US president Donald Trump's hawkish approach to China appears to command broad public and political support in the US. Two of the leading contenders for the Democratic presidential nomination, Bernie Sanders and Elizabeth Warren, are no less protectionist in their outlook than Mr Trump.

As protectionism creeps from trade to technology to intellectual property it becomes more complex and harder to resolve. Governments are increasingly scrutinising digital networks, tech company profits and cross-border data flows. Digital technology is a major area of disagreement not just between the US and China but between the US and the EU. Geopolitics and regulation are increasingly impinging on trade. Globalisation is getting more complex.

Economic and political update

Digital – the nine big shifts

The Social Enterprise

Reporting on climate change

Diversity and inclusion

The 2020 Stewardship Code

Managing risk

Internal control and the board

Non-executive pay

The Section 172(1) Statement

FRC reporting messages

Reporting on the 2018 Code

Taxation and state aid

Simplifying corporate structures

Audit market reform update

Appendix



### The risk of the slowdown becoming a recession is rising

Recent data has shown that the number of people in employment in the UK has fallen by 56,000. Long the standout success in Britain's recovery the jobs market is feeling the chill winds of weaker growth. Brexit has played a role, but in reality weakening UK activity is a small part of a wider, global story.

The synchronised economic upswing of 2016-18, which lifted rich and developing countries alike, has gone into reverse. Not only are Germany, Britain and the US cooling; so too are India, China and Russia. On the face of it the International Monetary Fund's (IMF) latest forecasts look fairly reassuring. They show the global economy growing by 3.0% this year, down from 3.6% last year and the weakest reading since the financial crisis, before picking up to 3.4% in 2020.

The global recovery started in 2009 and is long in the tooth. The world is overdue a slowdown. The fact that the IMF, and most economists, are forecasting a short-lived downturn, a classic 'soft-landing', might seem like good news. But when growth is softening, as it is now, forecasts are more than usually lagging and fallible.

What matters more than the IMF's forecasts is their analysis. It is downbeat. The slowdown has come faster than the IMF expected with the effects of trade tensions proving more pervasive and damaging than the IMF, or most economists, had anticipated. Rising tariffs and the increasing politicisation of trade policy have sown uncertainty and hit exports. Manufacturing, with its heavy reliance on export sales, has been a conspicuous casualty with output slowing sharply across the West. Globalisation, at least measured in terms of trade, has almost ground to a halt.

Germany's precipitous downturn, which will make it one of the rich world's slowest growing economies this year and next, is largely due to weaker exports. Its huge trade surplus, success

in the Chinese market and prowess in auto manufacturing have long been sources of strength. But, as global trade and Chinese demand sag, and with environmental worries and the downturn weighing on car sales, they have become vulnerabilities.

Business sentiment is heading down around the world. Uncertainty about future demand makes investing riskier. For businesses seeking to strengthen their balance sheet for the downturn, cost cutting, not investment, is the priority.

So far, consumer demand has held up reasonably well. But the consumer cannot decouple forever from the fortunes of the private sector. Recent disappointing UK jobs data show that, eventually, wages and jobs reflect what is happening in business.

With interest rates in the West at historically low levels, the scope for policymakers to counter weaker growth with monetary stimulus is less than it was on the eve of the last downturn. Central banks' firepower is depleted though not exhausted. This means that more of the burden of resisting the downturn is likely to fall on fiscal policy, in the form of increased government spending and tax cuts.

The Trump administration implemented sweeping tax cuts last year. From a policy point of view it was conspicuously ill-timed, coming at a time of near full employment and adding to an already strong recovery. More recently China has leaned against its slowdown by cutting taxes and Britain's new chancellor has effectively jettisoned public sector austerity. With many governments in Europe facing negative interest rates on their debt, and therefore being paid by the private sector to borrow, others seem likely to follow the UK.

Economic and political update

Digital – the nine big shifts

The Social Enterprise

Reporting on climate change

Diversity and inclusion

The 2020 Stewardship Code

Managing risk

Internal control and the board

Non-executive pay

The Section 172(1) Statement

FRC reporting messages

Reporting on the 2018 Code

Taxation and state aid

Simplifying corporate structures

Audit market reform update

Appendix



### Crunching the credit signals

In the latter part of last year central banks in the rich world were poised to tighten monetary policy. The US Federal Reserve was expected to continue raising interest rates and the European Central Bank (ECB) president Mario Draghi had announced the end of its programme of quantitative easing.

Faced with a gathering global slowdown central banks have U-turned, switching from tightening to easing monetary policy. The Fed has cut rates for the third time in three months. The ECB has recently cut rates further into negative territory and restarted asset purchases. Interest rates are at historic lows in the UK, with the base rate at just 0.75% and markets anticipate the next move by the Bank of England will be down.

Rate cuts and central bank asset purchases aim to reduce the cost, and increase the supply of credit, in order to bolster growth. Central banks have huge influence over credit conditions – but not complete control. The propensity of banks to lend and corporates to borrow is also influenced by the economic outlook. The prospect of weaker growth is likely to make banks more reluctant to lend, and the private sector more wary of borrowing. Taking on debt is less attractive when growth is weak, uncertainty is high and asset prices are under pressure.

The Bank of England's regular survey of banks shows that UK lenders are increasingly concerned about the outlook for growth and expect corporate defaults to rise. As a result banks have become more risk averse and are planning to cut back lending to corporates.

A Confederation of British Industry survey of manufacturers reports that in the last six months the cost of credit has had a more adverse effect on manufacturing investment than during the financial crisis. Demand for credit is slowing.

Big UK corporates are more focussed on reducing levels of debt than at any time in the last nine years, according to the latest Deloitte CFO Survey. Just as banks are paring back risk appetite so are corporates.

This makes sense. GDP growth and profits have done well in most Western countries in recent years. But with corporate earnings not far off a cyclical peak and activity slowing the outlook for profits looks less rosy. Corporate bankruptcies in the US and UK are starting to nudge up. This isn't only a problem for banks. Corporate bond markets are also at risk.

The cheap-money policies of recent years have lowered the return on safe assets and encouraged investors to move into riskier areas, including corporate debt, in search of higher returns. Non-financial corporates have taken advantage of the new source of funding to switch from equity to cheaper debt finance. In the US, the euro area and China non-financial businesses are running higher levels of debt today than they were ten years ago. (The UK is the exception. Its corporate sector has deleveraged and is now less indebted than those in the euro area and, indeed, China.)

In recent years even less creditworthy businesses have enjoyed easy credit conditions. Credit has been cheap and easy to find. As growth slows banks and the corporate bond market will become more discriminating in their lending decisions.

As directors contemplate big decisions in the year ahead, resilience will likely become a more commonly used term in the boardroom.

Economic and political update

Digital – the nine big shifts

The Social Enterprise

Reporting on climate change

Diversity and inclusion

The 2020 Stewardship Code

Managing risk

Internal control and the board

Non-executive pay

The Section 172(1) Statement

FRC reporting messages

Reporting on the 2018 Code

Taxation and state aid

Simplifying corporate structures

Audit market reform update

Appendix





# The nine big shifts – Moving from ‘doing digital’ to ‘being digital’

In this article we examine the steps companies need to take to make the most of the opportunities, whilst avoiding the threats, from successive waves of new digital technologies.

In organisations that recognise the need for digital transformation, we often observe a mismatch between their emerging digital strategy and their existing – more traditional – IT operating model and systems. Symptoms of this are lack of speed, lack of innovation, risk avoidance and shortage of modern digital skills. In other words, we see isolated initiatives that have limited connection to the company’s business model and, as a result, have limited impact on the business.

Deloitte research has identified nine big shifts that aim to future proof the entire company and master the capabilities that deliver business-relevant digital technologies rapidly, successively and at scale. This is not about an improved operating model for the IT department – this is about fundamentally changing the way the business identifies, trials, evaluates and scales new digital technologies to make them business-relevant.



**Big shift 1:**  
Agility and speed

As disruption becomes more pervasive, organisations will need to change course in real time based on market realities. Companies can choose to aspire to be a ‘fast moving experimenter’ running multiple smaller experiments in parallel, which they either scale or kill depending on outcomes. Alternatively, they can be ‘talent and strategy led’ with a limited number of big bets, based on a long-term strategy.



**Big shift 2:**  
Innovation and ecosystems

To innovate repeatedly, companies need to organise themselves to do so. Companies who are good at this have organised their digital disruption radar screen to sense “what’s coming in digital technology”. They have well prepared joint business and IT meetings in which they identify potential digital disruptive technologies. By joining resources, the business ecosystem can create new business models, services and customer experiences that would have been out of reach of the individual actors.

Economic and political update

Digital – the nine big shifts

The Social Enterprise

Reporting on climate change

Diversity and inclusion

The 2020 Stewardship Code

Managing risk

Internal control and the board

Non-executive pay

The Section 172(1) Statement

FRC reporting messages

Reporting on the 2018 Code

Taxation and state aid

Simplifying corporate structures

Audit market reform update

Appendix





**Big shift 3:**  
Blurring boundaries

In the digital era, companies are likely to require that virtually every line of business and every worker has a level of technology skill. To engage in and contribute to a tech-driven business environment, staff and management should become tech fluent. This shift “disrupts” the traditional monopoly of the IT department on access to, knowledge about and funding for information technology.



**Big shift 4:**  
Future workforce

Businesses will experience huge people challenges as existing IT tasks and capabilities disappear, remaining IT tasks transform and new IT tasks emerge. New skillsets such as design thinking, human-centric design, data science, growth hacking and hypothesis generation will be fundamental requirements in the future. Many of these skills are scarce in traditional IT organisations, so acquiring them will likely be a major challenge for existing IT workforces.



**Big shift 5:**  
Governance and funding

Due to digital, the role of technology in the enterprise is set to expand, so three fundamental changes should be considered. First, a larger share of the budget should be allocated to innovation at the cost of traditional technology expense. Second, the total technology spend is likely to increase, since new digital technology cannot be funded from cost savings alone. Third, companies may choose to fund digital innovation from outside the traditional IT budget.



**Big shift 6:**  
Leadership and culture

Digital leadership is about having a compelling digital vision to get people pulling in the same direction. Digital leaders have a distinct set of skills and capabilities. They have a deep understanding of the digital world in combination with business acumen and domain-specific knowledge. They are change agents, strong in building relationships and in influencing others to create buy-in and build trust.

Economic and political update

Digital – the nine big shifts

The Social Enterprise

Reporting on climate change

Diversity and inclusion

The 2020 Stewardship Code

Managing risk

Internal control and the board

Non-executive pay

The Section 172(1) Statement

FRC reporting messages

Reporting on the 2018 Code

Taxation and state aid

Simplifying corporate structures

Audit market reform update

Appendix





**Big shift 7:**  
Organise for digital

Together with cloud and data, digital has been one of the three macro forces shaping business technology innovation in the past decade. This first wave is characterised as focusing on digital experience. Although this first wave is still playing out, the next wave is rapidly approaching. This will be driven by technologies such as augmented reality, virtual reality, IoT, digital twins and intelligent interfaces (voice control, virtual assistants). Businesses should not ignore the power of these future waves and need to organise themselves to make digital transformation a success.



**Big shift 8:**  
Organise for data

The role of data and analytics is shifting from merely analysing what has happened (the rear-view mirror) to real-time views into what is happening, and even further to the ability to predict what will happen next and to prescribe a recommended response. The model to consider is to have a central team responsible for developing advanced data capabilities that are shared with domain teams which are organised where the business value is created.



**Big shift 9:**  
Organise for cloud

Traditionally, centralised IT departments supported the business with services such as selecting, deploying and scaling applications and infrastructure. Adoption of cloud computing combined with automating tasks previously done manually means that traditional management of these resources by central IT will, in time, cease to exist.

**Questions for boards to consider**

- How mature is your organisation's digital journey? Are you still in earlier phases: leveraging digital technologies to extend operational capabilities (often focused on customer channels only), while still relying on traditional business, operations and talent? Or have you reached higher levels of digital maturity where digital traits and a digital mindset define corporate outlook and behaviour?
- Rather than simply 'doing' digital projects, has the organisation adopted an integrated strategy that makes you digital at the core of the business?

Economic and political update

Digital – the nine big shifts

The Social Enterprise

Reporting on climate change

Diversity and inclusion

The 2020 Stewardship Code

Managing risk

Internal control and the board

Non-executive pay

The Section 172(1) Statement

FRC reporting messages

Reporting on the 2018 Code

Taxation and state aid

Simplifying corporate structures

Audit market reform update

Appendix



# Leading the social enterprise – reinvent your company with purpose

This article examines some key human capital trends in 2019 and how companies are responding by redesigning organisational behaviour. We present five “human principles” to ensure a focus on employees and help companies to respond rapidly in today’s changing environment.

## Alignment of purpose and culture

In the 2018 UK Corporate Governance Code, the Financial Reporting Council sets out a holistic vision of companies with an alignment of corporate purpose, values, strategy and culture.

Both the Principles and the new considerations around alignment with and oversight of the workforce and human capital policies work towards this vision. Principle B is key to the purpose of the organisation, as it requires the board to “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.”

[In our annual human capital survey publication, 2019 Global Human Capital Trends](#), we explored the results of a global survey which generated responses from more than 9,400 leaders across 119 countries.

One of our key human capital trend findings in the UK has clear links to corporate purpose, as it relates to putting meaning back into work:



81% of UK respondents rated ‘employee experience’ as important or very important to their organisation



Yet only 42% of UK respondents consider their organisation to be effective or very effective at providing meaningful work

This type of feedback from the workforce and the response of the board is likely to become more visible with the 2018 Code’s requirements around workforce engagement and for meaningful interaction with stakeholders. It may also become more visible to the users of annual reports as boards respond to the new legislative requirements in the UK for the s172(1) statement.

Economic and political update

Digital – the nine big shifts

The Social Enterprise

Reporting on climate change

Diversity and inclusion

The 2020 Stewardship Code

Managing risk

Internal control and the board

Non-executive pay

The Section 172(1) Statement

FRC reporting messages

Reporting on the 2018 Code

Taxation and state aid

Simplifying corporate structures

Audit market reform update

Appendix



### Five human principles

In response to the findings of our global human capital survey, we designed a set of benchmarks that boards and HR professionals can consider when planning to future-proof their organisation. We defined the “social enterprise” as one that combines both growth and profit with a focus on a positive and sustainable impact. These five “human principles” can ensure the social enterprise maintains a human focus and help organisations to respond rapidly in a changing environment.

Design Principle	What it means
Purpose and meaning	Giving organisations and individuals a sense of purpose at work; moving beyond profit to a focus on doing good things for individuals, customers and society
Ethics and fairness	Using data, technology, and systems in an ethical, fair, and trusted way; creating jobs and roles to train systems and monitor decisions to make sure they are fair
Growth and passion	Designing jobs, work, and organisational missions to nurture passion and a sense of personal growth; affording people the opportunity to create and add their own personal touch
Collaboration and personal relationships	Building and developing teams, focusing on personal relationships, and moving beyond digital to build human connections at work
Transparency and openness	Sharing information openly, discussing challenges and mistakes, and leading and managing with a growth mindset

Economic and political update

Digital – the nine big shifts

The Social Enterprise

Reporting on climate change

Diversity and inclusion

The 2020 Stewardship Code

Managing risk

Internal control and the board

Non-executive pay

The Section 172(1) Statement

FRC reporting messages

Reporting on the 2018 Code

Taxation and state aid

Simplifying corporate structures

Audit market reform update

Appendix



### How do the principles impact the human experience?

- **Purpose and meaning** – ensuring that each individual worker has a sense of purpose and believes they make an impact. This should be linked to refreshing the reward system to ensure that this too reflects the purpose and meaning of each role and works towards the individual’s personal growth objectives.
- **Ethics and fairness** – using data, technology and systems to help organisations monitor that decisions taken are fair and transparent, rethinking the HR technology strategy, to consider cloud as a foundation and to explore innovative new platforms, automation, and AI-based tools to complement their core system.
- **Growth and passion** – incorporating the personal touch, taking advantage of talent mobility and the alternative workforce. Organisations that take this workforce seriously can build strategies and programs to access and engage talented people wherever they may sit in the labour pool, driving business growth and extending the diversity of the workforce.
- **Collaboration and personal relationships** – when parts of jobs are automated by machines, the work that remains for humans is generally more interpretive and service oriented, involving problem-solving, data interpretation, communications and listening, customer service and empathy, and teamwork and collaboration. As organisations move into service-centre business models, they should consider shifting from hierarchies to cross-functional teams.

- **Transparency and openness** – sharing information openly and learning from mistakes collectively. To be effective, leaders should lead by example, promoting inclusion, fairness and transparency as key elements of corporate culture and values.

We anticipate that UK companies will develop a far deeper understanding of the attitude of their workforce over the next few years.

#### Questions for boards to consider

- Is your corporate purpose and your culture well-aligned and linked to both job roles and to the reward system? Does the corporate purpose inform individual personal growth objectives?
- Have you considered how the organisation will be transformed by technology and whether any adaptation of organisational structures needs to be considered?
- Does the board and do executive leaders within your organisation show themselves to be transparent, open and learning from mistakes?

Economic and political update

Digital – the nine big shifts

The Social Enterprise

Reporting on climate change

Diversity and inclusion

The 2020 Stewardship Code

Managing risk

Internal control and the board

Non-executive pay

The Section 172(1) Statement

FRC reporting messages

Reporting on the 2018 Code

Taxation and state aid

Simplifying corporate structures

Audit market reform update

Appendix



# *Responsible business*

Economic and political update

Digital – the nine big shifts

The Social Enterprise

Reporting on climate change

Diversity and inclusion

The 2020 Stewardship Code

Managing risk

Internal control and the board

Non-executive pay

The Section 172(1) Statement

FRC reporting messages

Reporting on the 2018 Code

Taxation and state aid

Simplifying corporate structures

Audit market reform update

Appendix



# Reporting on climate change

With the UK drive towards a zero carbon economy by 2050, expectations are rising from investors, regulators and others for more in-depth and informative reporting on climate change in company annual reports. This article explains what must be disclosed in 2019/20 annual reports and also, for those who have made the commitment and/or are starting on this journey, outlines some key considerations for reporting under the TCFD framework.

## Reporting expectations set by the FRC

Following the Government's announcement of its new target to bring all greenhouse gas emissions to net zero by 2050, in July 2019 it announced the Green Finance Strategy, which recognises the role of the financial sector in delivering global and domestic climate and environmental objectives.

At that time the FRC issued a joint statement with other financial regulators, making its expectations of UK boards and company reporting very clear. The Boards of UK companies have a responsibility to consider their impact on the environment and the likely consequences of any business decisions in the long term. Omitting consideration of the impacts of climate change where relevant would question whether the board has fulfilled its duties and whether the strategic report is comprehensive.

## The path to reporting under the TCFD framework

In the Green Finance Strategy, the Government also proposed mandatory TCFD disclosures by 2022. The FCA has published proposals and its intention to consult in early 2020 on new disclosure rules for certain listed issuers aligned with the TCFD's recommendations, initially on a 'comply or explain' basis.

The FRC's Financial Reporting Lab ("the Lab") published a report in October 2019, [Climate-related corporate reporting](#), which aims to reflect the views of investors on existing reporting by companies and to help companies move towards more effective and comprehensive reporting.

### The FRC has made clear that:

*"Boards should therefore address, and where relevant report on, the **effects of climate change (both direct and indirect)**.*

*Reporting should set out how the company has taken into account the resilience of the company's business model and its **risks, uncertainties and viability in both the immediate and longer-term in light of climate change**.*

*Companies should also reflect the current or future **impacts of climate change on their financial position**, for example in the valuation of their assets, assumptions used in impairment testing, depreciation rates, decommissioning, restoration and other similar liabilities and financial risk disclosures."*

Economic and political update

Digital – the nine big shifts

The Social Enterprise

Reporting on climate change

Diversity and inclusion

The 2020 Stewardship Code

Managing risk

Internal control and the board

Non-executive pay

The Section 172(1) Statement

FRC reporting messages

Reporting on the 2018 Code

Taxation and state aid

Simplifying corporate structures

Audit market reform update

Appendix





Helpfully, rather than creating a separate framework, the Lab report is structured around the TCFD framework as many companies reported that the TCFD had helped them align their thinking and provided a clearer route to reporting.

The Lab's report sets out the TCFD recommendations together with challenging questions proposed by the Lab and examples of good practice.

TCFD recommendations	A selection of questions for boards to consider	Good practice examples
<b>Governance</b>		
<p>Disclose the organisation's governance around climate-related risks and opportunities:</p> <ul style="list-style-type: none"> <li>Describe the board's oversight of climate-related risks and opportunities</li> <li>Describe management's role in assessing and managing climate-related risks and opportunities</li> </ul>	<ul style="list-style-type: none"> <li>What arrangements does the board have in place for assessing and considering climate-related issues? What is the board's view of the climate change challenge, and what assumptions is it making?</li> <li>Who has responsibility for climate-related issues? How are the board and/or committees involved and how often are climate-related issues considered?</li> <li>Is the board preparing for different outcomes where there is uncertainty?</li> <li>What competence and expertise does the board feel it needs, or needs access to, in order to consider and address the challenges climate-related issues pose?</li> <li>Is the organisation planning to report against the TCFD? If so, what can be shared about the progress made and what are the plans for disclosure?</li> </ul>	<ul style="list-style-type: none"> <li>Details of information the board sees (Royal Dutch Shell)</li> <li>Governance arrangements in place (Unilever)</li> <li>Who has responsibility, and a consideration of the necessary competence (National Grid)</li> </ul>

Economic and political update

Digital – the nine big shifts

The Social Enterprise

Reporting on climate change

Diversity and inclusion

The 2020 Stewardship Code

Managing risk

Internal control and the board

Non-executive pay

The Section 172(1) Statement

FRC reporting messages

Reporting on the 2018 Code

Taxation and state aid

Simplifying corporate structures

Audit market reform update

Appendix



TCFD recommendations	A selection of questions for boards to consider	Good practice examples
<b>Business model and strategy</b>		
<p>Disclose the actual and potential impacts of climate-related risks and opportunities on the organisation's businesses, strategy, and financial planning where such information is material</p> <ul style="list-style-type: none"> <li>Describe the climate-related risks and opportunities the organisation has identified over the short, medium and long term</li> <li>Describe the impact of climate-related risks and opportunities on the organisation's businesses, strategy and financial planning</li> <li>Describe the resilience of the organisation's strategy, taking into consideration different climate-related scenarios, including a 2 degree or lower scenario</li> </ul>	<ul style="list-style-type: none"> <li>What does the company look like in the future and how will it continue to generate value? What strategy does the company have for responding to the challenges?</li> <li>Has the company considered the impact of low-carbon transition as well as physical risk?</li> <li>How resilient is the business model to climate change? How does the company respond to a 1.5 degree, 2 degree or more world?</li> <li>What strategy has been put in place to reach that aim, and what operational or capital expenditures are needed to address any necessary business model changes?</li> <li>How does the information gathered factor into strategic planning? What triggers would require a change of direction?</li> </ul>	<ul style="list-style-type: none"> <li>The resilience of the business model and opportunities, including a quantification of these risks and opportunities (SSE)</li> <li>Where specific aspects of their business model may be affected and their capacity to respond (Stora Enso Oyj)</li> <li>Opportunities a changing climate presents to the business (Halma)</li> <li>Outline strategic plans for reaching net zero by 2050 (General Mills)</li> <li>An indication of strategic decisions being made in light of 1.5 degree pathway (Ørsted)</li> <li>Explanation of the challenges a company faces at each asset location (Fresnillo)</li> <li>Disclosure of internal carbon price used for strategic planning purposes (Oil Search Ltd)</li> <li>Discussion of the horizons over which different issues have been considered, and what those timeframes are (Land Securities Group, Aviva, Bloomberg)</li> </ul>

Economic and political update

Digital – the nine big shifts

The Social Enterprise

Reporting on climate change

Diversity and inclusion

The 2020 Stewardship Code

Managing risk

Internal control and the board

Non-executive pay

The Section 172(1) Statement

FRC reporting messages

Reporting on the 2018 Code

Taxation and state aid

Simplifying corporate structures

Audit market reform update

Appendix



TCFD recommendations	A selection of questions for boards to consider	Good practice examples
<b>Risk management</b>		
<p>Disclose how the organisation identifies, assesses, and manages climate-related risks</p> <ul style="list-style-type: none"> <li>Describe the organisation's processes for identifying and assessing climate-related risks</li> <li>Describe the organisation's processes for managing climate-related risks</li> <li>Describe how processes for identifying, assessing, and managing climate-related risks are integrated into the organisation's overall risk management</li> </ul>	<ul style="list-style-type: none"> <li>What systems and processes are in place for identifying, assessing and managing climate-related risks? To what extent can current processes be developed to assist?</li> <li>How is a consideration of climate-related issues integrated into the risk management process and connected to other related risks?</li> <li>Over what horizons have the risks been considered and risk assessments carried out?</li> <li>How is the assessment of the company's viability over the longer-term taking into account climate-related issues?</li> <li>Are the scenarios sufficiently diverse and challenging? How is the scenario analysis used in strategic planning?</li> </ul>	<ul style="list-style-type: none"> <li>Risk management process in place (Swiss Re)</li> <li>Information on Audit Committee oversight (National Grid)</li> <li>Risks in relation to key specific assets (Diageo)</li> <li>Benchmarked results and changes made (Johnson Matthey)</li> <li>Asset-based outcomes referring to specific scenarios (Oil Search, Rio Tinto)</li> <li>Monitoring with indicators and reference to future strategic decisions (Bloomberg)</li> <li>Climate in the viability statement (Royal Dutch Shell)</li> <li>Assumptions made and impact of different scenarios (Unilever)</li> <li>Information about specific external expertise sought (Royal Dutch Shell)</li> </ul>

Economic and political update

Digital – the nine big shifts

The Social Enterprise

Reporting on climate change

Diversity and inclusion

The 2020 Stewardship Code

Managing risk

Internal control and the board

Non-executive pay

The Section 172(1) Statement

FRC reporting messages

Reporting on the 2018 Code

Taxation and state aid

Simplifying corporate structures

Audit market reform update

Appendix



TCFD recommendations	A selection of questions for boards to consider	Good practice examples
<b>Metrics and targets</b>		
<p>Disclose the metrics and targets used to assess and manage relevant climate-related risks and opportunities where such information is material</p> <ul style="list-style-type: none"> <li>• Disclose the metrics used by the organisation to assess climate-related risks and opportunities in line with its strategy and risk management process</li> <li>• Disclose Scope 1, Scope 2 and, if appropriate, Scope 3 greenhouse gas (GHG) emissions, and the related risks</li> <li>• Describe the targets used by the organisation to manage climate-related risks and opportunities and performance against targets</li> </ul>	<ul style="list-style-type: none"> <li>• What information is most relevant to monitoring and managing the impacts of climate-related issues? How were these identified and how do they link to the strategy and business model?</li> <li>• What do the metrics being monitored and managed indicate about the future direction of the company? How is this information used? How are they being integrated into day-to-day business management and reporting?</li> <li>• To what level of oversight or assurance have the metrics been subjected?</li> <li>• Are the metrics disclosed calculated consistently? Is trend data provided?</li> <li>• Which methodology has been used for constructing the metrics? Is this comparable to other companies in the sector?</li> <li>• How are metrics being integrated into the remuneration policies? Is this the most effective linkage possible?</li> </ul>	<ul style="list-style-type: none"> <li>• Linkage of remuneration to climate-related metrics (Royal Dutch Shell, SSE)</li> <li>• Involvement of a committee (National Grid)</li> <li>• Competitive advantage (Diageo)</li> <li>• Key metrics such as 'Climate-Value-at-risk' (AXA)</li> <li>• Carbon footprints and how these are assessed and used (Aviva)</li> <li>• Presenting performance in a user-friendly manner (UBS, DS Smith, National Grid)</li> <li>• Reference to scope 1, 2 and 3 emissions and related intensity (Fresnillo)</li> <li>• Methodologies for Scope 3 emissions across time (Go-Ahead Group)</li> <li>• Explanation of changes in calculations, changes from the previous year and scope and boundary (Associated British Foods)</li> </ul>

- Economic and political update
- Digital – the nine big shifts
- The Social Enterprise
- Reporting on climate change
- Diversity and inclusion
- The 2020 Stewardship Code
- Managing risk
- Internal control and the board
- Non-executive pay
- The Section 172(1) Statement
- FRC reporting messages
- Reporting on the 2018 Code
- Taxation and state aid
- Simplifying corporate structures
- Audit market reform update
- Appendix



### European Commission Technical Expert Group on Sustainable Finance

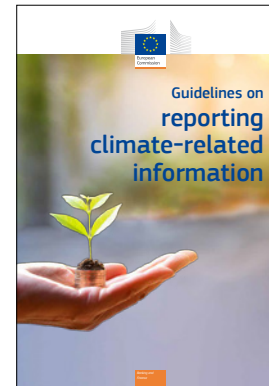
The European Commission has determined that investors and issuers need common metrics and definitions for what activities contribute positively to environmental objectives. Common language and harmonisation would enhance market efficiency and redirect financial flows to support transition towards a more sustainable economy.

In June 2018, the European Commission set up a Technical Expert Group on sustainable finance (TEG) to develop four publications:

- 1) A taxonomy for sustainable economic activities.
- 2) European Union (EU) Green Bond Standard.
- 3) Benchmarks for low-carbon investment strategies, and
- 4) Guidance to improve corporate disclosure of climate-related information, which reinforces the FRC's expectations on climate reporting and the move towards implementation of TCFD

#### What should directors do this year end

- Ensure that climate change is regularly on the board agenda and that governance over climate change has been established.
- Ensure both the risks climate change poses to the business and the risk that the business poses to the climate have been considered when establishing principal risks and drafting the strategic report.
- Consider how to disclose climate change in the strategic report, taking into account the FRC's expectations and assessing how far the business can go towards meeting the TCFD recommendations.
- For the audit committee, query what assumptions, judgements and estimates relating to climate risk have been incorporated into the preparation of the financial statements. For example, where you have performed scenario analysis, has this been reflected in cash flow forecasts supporting impairment reviews and other asset valuations?



Economic and political update

Digital – the nine big shifts

The Social Enterprise

Reporting on climate change

Diversity and inclusion

The 2020 Stewardship Code

Managing risk

Internal control and the board

Non-executive pay

The Section 172(1) Statement

FRC reporting messages

Reporting on the 2018 Code

Taxation and state aid

Simplifying corporate structures

Audit market reform update

Appendix



# Diversity and inclusion

In this article we explore where we are on board diversity and diversity reporting and consider the recent findings of the Hampton-Alexander review. There remains room for improvement!

## Board diversity reporting - requirements for the 2019 annual report

In recent years there have been numerous government initiatives around board diversity. The Davies Review (2011) on gender diversity has passed the baton to the Hampton-Alexander Review (2016). The Parker Review (2016) focused on ethnic diversity at board level, supported by the McGregor-Smith Review (2017) on broader BAME diversity in business. Supporting these initiatives from the investment side, major investors such as Legal & General Investment Management and Aviva have made voting commitments to encourage companies to do more around gender diversity.

The FRC sees diversity as key to an effective boardroom dynamic, helping to avoid groupthink and complacency and, in the 2018 UK Corporate Governance Code, has introduced new requirements around consideration and reporting of diversity,

both in the boardroom and going beyond the boardroom. These requirements are set out below together with clarity on how the Code disclosures fit with the Disclosure Guidelines and Transparency Rules (DTR) requirements.

Diversity and inclusion are also explored in several of the more detailed provisions, including Provision 23 asking for companies to describe the linkage between the diversity and inclusion policy and company strategy. This has linkage to disclosure requirements that companies often include in the strategic report which companies may wish to refer to in their new section 172(1) statement. Companies will need to plan carefully where these disclosures sit in their annual report and what linkage and cross-referencing will be helpful to readers.

The 2018 Code	What do you need to disclose?
<p><b>Principle J:</b> Both appointments and succession plans should be based on merit and objective criteria and, within this context, should promote diversity of gender, social and ethnic backgrounds, cognitive and personal strengths.</p>	<p>Boards must explain how this principle has been applied in practice. For example:</p> <ul style="list-style-type: none"> <li>• A summary of the board appointment process. [Link to Code Provisions 17, 20 &amp; 23]</li> <li>• The succession planning process for board and senior management including the development of a diverse talent pipeline and consideration of the length of service of the board as a whole. [Link to Code Provision 17]</li> <li>• The composition of the board in terms of skills, experience and knowledge and the approach of the board to maintaining an appropriate balance of skills, experience and knowledge.</li> </ul>

Economic and political update

Digital – the nine big shifts

The Social Enterprise

Reporting on climate change

Diversity and inclusion

The 2020 Stewardship Code

Managing risk

Internal control and the board

Non-executive pay

The Section 172(1) Statement

FRC reporting messages

Reporting on the 2018 Code

Taxation and state aid

Simplifying corporate structures

Audit market reform update

Appendix



The 2018 Code	What do you need to disclose?
<p><b>Principle L:</b> Annual evaluation of the board should consider its composition, diversity and how effectively members work together to achieve objectives.</p>	<p>Boards must explain how this principle has been applied in practice. For example:</p> <ul style="list-style-type: none"> <li>The board’s approach to assessing its effectiveness. [Link to Code Provisions 21 to 23]</li> </ul>
<p><b>Provision 23:</b> The annual report should describe the work of the nomination committee, including:</p> <ul style="list-style-type: none"> <li>the process used in relation to appointments, its approach to succession planning and how both support developing a diverse pipeline; and</li> <li>the policy on diversity and inclusion, its objectives and linkage to company strategy, how it has been implemented and progress on achieving the objectives.</li> </ul>	<p>The process the board has used in relation to board appointments, its approach to succession planning (both at board and senior management levels) and how both support developing a diverse pipeline.</p> <p>The policy on diversity and inclusion, its objectives and linkage to company strategy, how it has been implemented and progress on achieving the objectives. Where a high quality disclosure is completed on this policy, distinguishing differences in policy and approach between different levels of the organisation, this part of the Code disclosure requirements should also lead to meeting the related DTR requirement:</p> <p><b>DTR 7.2.8AR:</b> (1) The corporate governance statement must contain a description of:</p> <ol style="list-style-type: none"> <li>the diversity policy applied to the issuer’s administrative, management and supervisory bodies with regard to aspects such as, for instance, age, gender, or educational and professional backgrounds;</li> <li>the objectives of the diversity policy in (a);</li> <li>how the diversity policy in (a) has been implemented; and</li> <li>the results in the reporting period.</li> </ol> <p>(2) If no diversity policy is applied by the issuer, the corporate governance statement must contain an explanation as to why this is the case.</p> <p>For this purpose, “pipeline” is explained in the Guidance on Board Effectiveness:</p> <p>“Developing a more diverse executive pipeline is vital to increasing levels of diversity amongst those in senior positions. Improving diversity at each level of the company is important if more diversity at senior levels is to become a reality.”</p>

- Economic and political update
- Digital – the nine big shifts
- The Social Enterprise
- Reporting on climate change
- Diversity and inclusion
- The 2020 Stewardship Code
- Managing risk
- Internal control and the board
- Non-executive pay
- The Section 172(1) Statement
- FRC reporting messages
- Reporting on the 2018 Code
- Taxation and state aid
- Simplifying corporate structures
- Audit market reform update
- Appendix



Our annual reporting survey of 100 listed companies, [Annual Report Insights 2019](#), showed that 22% of companies picked up on the new Code requirement (in Provision 23) to explain how their process in relation to appointments or their approach to succession planning supports developing a diverse pipeline.

The survey also found that only 30% of companies indicated that they had diversity targets for the board, although this had improved from 22% in 2018. However, less than half of companies described their board diversity policy, its objectives and outcomes, which is a requirement of the DTR, or if they do not describe the policy, they need to explain why not.



**30%** of companies indicated they had diversity targets for the board, **up from 22% in 2018**.

**48%** of companies met the DTR requirements to describe **the board diversity policy** (2018:29%).

It does look as though there is still room for improvement in the board's disclosures on diversity and, as set out in this article the new Code seeks to further reinforce the importance of transparency in this area.

#### ISS focus on board gender diversity

Board gender diversity is also a focus area for the proxy agency ISS. Its new [policy](#) for 2020 annual reports includes plans to vote against the chair of the nomination committee (or other directors on a case-by-case basis) when there are no female directors on the board of widely-held companies.

IVIS, the proxy agency of the Investment Association, already gives "red top" reports to companies with one or no women on the board, and amber tops to those where less than 25% of the board are women.

#### Workforce Diversity

Studies have repeatedly shown that increasing diversity is not just the right thing to do for an organisation's culture, it also leads to better business outcomes. Increased diversity leads to better decision-making, contributes to an organisation's bottom line, and powers innovation, among other benefits.

The 2018 Code expects companies to include not just UK employees but to consider the wider workforce. The Guidance on Board Effectiveness (paragraph 50) calls on companies to consider the following:

- The workforce involves not just those with formal contracts of employment (permanent, fixed-term and zero-hours).
- Companies should consider including individuals engaged under contracts of service, agency workers, and remote workers, regardless of their geographical location.
- Companies should be able to explain who they have included and why.

Challenges when considering this broad definition of the workforce include, but are not limited to:

- Not all the workforce will have equivalent access to IT or learning opportunities.
- Dissemination of learning on diversity and inclusion, together with other information on values and culture, may be complex.
- Considering how policies and practices will drive behaviours in different parts of the world.
- Global values but local legislation.
- Difficulty of maintaining data protection and communicating data privacy challenges.

Boards may benefit from asking for input from risk, internal audit and human resources departments around the challenges with their particular shape of workforce and the associated management and mitigation plans.

Economic and political update

Digital – the nine big shifts

The Social Enterprise

Reporting on climate change

Diversity and inclusion

The 2020 Stewardship Code

Managing risk

Internal control and the board

Non-executive pay

The Section 172(1) Statement

FRC reporting messages

Reporting on the 2018 Code

Taxation and state aid

Simplifying corporate structures

Audit market reform update

Appendix





### Latest findings from the Hampton-Alexander Review

The Hampton-Alexander Review, which aims to improve the representation of women in leadership positions of FTSE 350 companies, published its [2019 report](#) on 13 November.

The Review focuses not only on gender diversity on boards, but also gender diversity of the chair, of executive directors and of the executive committee, including direct reports to the executive committee. Its target is having 33% of all board and senior leadership positions held by women by the end of 2020.

The 2019 report indicates that if the pace of change is continued, FTSE 350 companies are on target to meet 33% of board positions being held by women by the end of 2020. Women hold 32.4% of all FTSE 100 board roles. However, there is slower progress towards targets below board level with only 28.6% women on the executive committee and its direct reports in the FTSE 100 and 27.9% in the FTSE 250.

### How does the UK compare to the rest of the world?

Deloitte has recently published the sixth edition of [Women in the Boardroom: A Global Perspective](#). This reports that women hold just 16.9 percent of board seats globally, only a 1.9 percent increase from the report's last edition published in 2017. Progress continues to be slow. Women hold just 4.4 percent of CEO positions globally. CFO positions are nearly three times more diverse, but women still hold just 12.7 percent of these positions globally. Given that many board members are recruited from the executive level, this also contributes to a shortage of women in the boardroom.

In countries with the highest or fastest growing boardroom gender diversity, there is no one-size-fits-all solution. Our data shows six countries that have over 30 percent women on boards: Norway, France, Sweden, Finland, New Zealand, and Belgium. Three of these six have implemented gender quota legislation, while the other half have addressed diversity efforts without gender quotas.

### The gender pay gap – EHRC reports 100% compliance

The gender pay gap reporting is now well-established and the Equality and Human Rights Commission (EHRC) reports 100% compliance, with over 10,500 employers publishing their annual gender pay gap by August 2019.

In a [blog](#) published on the EHRC website, Rebecca Hilsenrath, CEO of the EHRC, raises her observations around gender pay gap reporting:

- Every employer needs someone to be a “responsible owner” – a “named senior person” who takes ownership of the gender pay gap reporting.
- Data isn’t always checked and isn’t always realistic.
- On a more positive note, some employers are looking closely at the causes of their pay gap and talking to staff about how to close the gap, and boards are increasingly paying attention to the gender pay gap.

### Ethnic diversity

#### In the boardroom

During July 2019, Kelly Tolhurst MP, as Minister for Small Business, Consumers and Corporate Responsibility, wrote to the Chairs of FTSE 350 companies to gather information on the ethnic diversity of the board in order to raise the profile of the ambition and assess progress on the Parker Review targets.

Our [Annual Report Insights 2019](#) shows that 11% of companies included disclosure on the level of ethnic diversity on their board, up from 6% - we expect this to increase again this coming year as companies approach the 2021 target date mentioned in the Parker Review, which calls for at least one BAME member on the board by 2021.

Economic and political update

Digital – the nine big shifts

The Social Enterprise

Reporting on climate change

Diversity and inclusion

The 2020 Stewardship Code

Managing risk

Internal control and the board

Non-executive pay

The Section 172(1) Statement

FRC reporting messages

Reporting on the 2018 Code

Taxation and state aid

Simplifying corporate structures

Audit market reform update

Appendix



### Ethnicity pay gap

In November 2018, the Department for Business, Energy and Industrial Strategy (BEIS) consulted on ethnicity pay reporting and ethnicity pay gap. The consultation closed in January 2019 and there have been no further government publications so far.

In an October 2019 speech entitled “Understanding Pay Gaps”, the chief economist of the Bank of England highlighted that 63% of employers monitor ethnicity pay gaps but only 31% of employers currently publish them. This level has increased since the publication of the Government’s consultation, indicating that the expectation of legislation in this area has helped companies decide to publish.

The Bank of England has started to publish its own ethnicity pay gap and encourages companies to track and perhaps to publish their own, using statistical techniques to interpret the results. It argues that “published pay gaps are a starting point for corporate and national accountability and explanation, not an end point... it prompts companies to justify their misses and to explain how and over what horizon they expect their pay gap and diversity targets to be hit.”

### Government Equalities Office “Lead the Change” Board

The government has created a Board to provide practical support to companies and to share good practices to help achieve the objectives of the various reviews, chaired by Emer Timmons and Denis Woulfe MBE.

As part of their work, the LACA “Lead the Change” Board will support the Hampton-Alexander Review to help target 33% of executive level FTSE 350 business leaders being women by the end of 2020. Board members will also work to increase the ethnic diversity in an effort to ensure that each FTSE 100 board should have at least one ethnic minority director by 2021, and each FTSE 250 board should have at least one ethnic minority director by 2024, supporting the work being delivered by Sir John Parker.

Deloitte is delighted to support this and two Deloitte partners have joined the board: Emma Codd and William Touche.

#### Questions for boards to consider:

- Have you considered whether the board’s policy on diversity at board level and the policy on diversity and inclusion throughout the organisation is in step with the new demands of the 2018 UK Corporate Governance Code? Are the policies clearly reported in the annual report, together with objectives and outcomes?
- Does your board treat diversity both at board level and throughout the organisation as an opportunity and a matter of strategic importance? Is it given sufficient time at board level?
- Do you have a clear view on the diversity challenges throughout your organisation, the actions being taken to increase diversity where necessary, and this year’s gender pay gap results?
- Do you have an understanding of your ethnicity pay gap and have you considered whether to report on the ethnicity pay gap publicly, before legislation demands it?

Economic and political update

Digital – the nine big shifts

The Social Enterprise

Reporting on climate change

Diversity and inclusion

The 2020 Stewardship Code

Managing risk

Internal control and the board

Non-executive pay

The Section 172(1) Statement

FRC reporting messages

Reporting on the 2018 Code

Taxation and state aid

Simplifying corporate structures

Audit market reform update

Appendix



# A new benchmark for stewardship – the 2020 Stewardship Code

In a bid to address criticisms raised by Sir John Kingman, the new Stewardship Code focuses more on stewardship activity by investors and outcomes rather than policies and processes. So directors should expect to experience more active engagement from their investors, particularly in relation to environmental, social and governance factors, including climate change, to support alignment throughout the investment chain.

## Introduction

The FRC hopes that [the new Code](#) establishes a clear benchmark for stewardship as the responsible allocation, management and oversight of capital to create long-term value for clients and beneficiaries leading to sustainable benefits for the economy, the environment and society.

New FRC Chief Executive, Sir Jon Thompson, has made expectations clear:

*“The FRC will be holding signatories to account by regular review of adoption of the new Code and the quality of the reporting against its principles. Asset owners and beneficiaries will then be able to see if those investing on their behalf are doing so in accordance with their needs and views. They will also be able to see the impact of their manager’s decisions, particularly in relation to environmental, social and governance issues, including climate change.”*

The Code is voluntary and sets an aspirational standard beyond minimum regulatory requirements in the UK. The Code now comprises 12 ‘apply and explain’ Principles for asset owners and asset managers, with reporting expectations relevant to their role. In addition, there are six, separate ‘apply and explain’ Principles for service providers, again with reporting expectations.

An organisation applying to become a signatory to the Code will need to provide a Stewardship Report that sets out how they have applied the Code Principles in the preceding 12 months. This must include reporting on the activities they have undertaken, and the outcomes achieved. For the organisation to be listed as a signatory on the FRC’s website, the Report will need to meet the reporting expectations set out in the new Code.

In his independent review of the FRC, Sir John Kingman stated that the Code should focus on outcomes and effectiveness, not on policy statements. Most respondents felt that the recommendations of the Kingman Review have been fully addressed in the proposed revisions to the Code and reporting requirements. The FRC has removed the requirement for a separate Policy and Practice statement upon signing up to the Code.

Economic and political update

Digital – the nine big shifts

The Social Enterprise

Reporting on climate change

Diversity and inclusion

The 2020 Stewardship Code

Managing risk

Internal control and the board

Non-executive pay

The Section 172(1) Statement

FRC reporting messages

Reporting on the 2018 Code

Taxation and state aid

Simplifying corporate structures

Audit market reform update

Appendix



### Key changes in the new Code

- An extended focus that includes the asset owners, such as pension funds and insurance companies, and service providers as well as asset managers. This is intended to help align the approach of the whole investment community in the interest of end-investors and beneficiaries.
- A requirement to report annually on stewardship activity and its outcomes. Signatories' reports will show what has actually been done in the previous year, and what the outcome was, including their engagement with the assets they invest in, their voting records and how they have protected and enhanced the value of their investments.
- Signatories will be expected to take environmental, social and governance factors, including climate change, into account and to ensure their investment decisions are aligned with the needs of their clients.
- Signatories are now expected to explain how they have exercised stewardship across asset classes beyond listed equity, such as fixed income, private equity and infrastructure, and in investments outside the UK.
- Signatories are required to explain their organisation's purpose, investment beliefs, strategy and culture and how these enable them to practice stewardship. They are also expected to show how they are demonstrating this commitment through appropriate governance, resourcing and staff incentives.

### Outcomes the FRC is seeking

In revising the Code the FRC is seeking to:

- Differentiate excellence in stewardship by setting high expectations for disclosure by investors and their agents on the activities and outcomes of stewardship and investment.
- Create a demand for effective stewardship by encouraging clear reporting on purposeful activity and publicly evaluating signatories' reporting. Reporting should enable asset owners and beneficiaries to understand how their agents and pension funds integrate stewardship and investment in their best interests.
- Support a regulatory framework for effective stewardship and investment in the UK economy, ensuring that the UK continues attract investment.

### Monitoring

The FRC will assess the effectiveness of the Code in meeting these outcomes: by monitoring the reporting quality of signatories which apply the Code; through ongoing engagement with stakeholders, by reviewing how the market uses stewardship reporting; and by seeking evidence through research and with other regulators, including the FCA.

Economic and political update

Digital – the nine big shifts

The Social Enterprise

Reporting on climate change

Diversity and inclusion

The 2020 Stewardship Code

Managing risk

Internal control and the board

Non-executive pay

The Section 172(1) Statement

FRC reporting messages

Reporting on the 2018 Code

Taxation and state aid

Simplifying corporate structures

Audit market reform update

Appendix



### Implementation and transition

The 2020 Code takes effect for reporting years beginning on or after 1 January 2020. The transition from the 2012 Code to the 2020 Code will be implemented as follows:

<b>31 December 2019</b>	The FRC will no longer accept new or updated statements against the 2012 Code after 31 December 2019.
<b>1 January 2020</b>	Organisations wishing to confirm their commitment to the Code before applying to become a signatory may request to be listed on the website.
<b>Throughout 2020</b>	The FRC will engage with investors to communicate expectations for the quality and content of Reports.
<b>31 March 2021</b>	Applicants seeking to be included in the first list of signatories to the Code must submit their Stewardship Reports by 31 March 2021.
<b>Summer 2021</b>	The FRC completes assessment of reports. Applicants that meet the FRC's expectations will be listed as 2020 Code signatories in a single list based on their role i.e. asset owner, asset manager or service provider. Signatories reporting in Year 1 will not be graded or tiered.

### Remainder of 2021

Following the first year of reporting against the 2020 Code, the FRC will:

- report on the quality of reporting and include examples of good practice in stewardship and reporting.
- encourage signatories to work together to develop good practice norms on reporting stewardship outcomes
- review the Code's reporting expectations, to ensure the Code remains up to date and continues to encourage effective stewardship.

### Matters for boards to consider

- What steps is the board taking to understand the views of major shareholders and to seek engagement with shareholders on significant matters related to their areas of responsibility?
- How much awareness does the board have of the share register and whether the company's major shareholders are signatories to the Stewardship Code?

Economic and political update

Digital – the nine big shifts

The Social Enterprise

Reporting on climate change

Diversity and inclusion

The 2020 Stewardship Code

Managing risk

Internal control and the board

Non-executive pay

The Section 172(1) Statement

FRC reporting messages

Reporting on the 2018 Code

Taxation and state aid

Simplifying corporate structures

Audit market reform update

Appendix



# *Risk & internal control*

Economic and political update

Digital – the nine big shifts

The Social Enterprise

Reporting on climate change

Diversity and inclusion

The 2020 Stewardship Code

Managing risk

Internal control and the board

Non-executive pay

The Section 172(1) Statement

FRC reporting messages

Reporting on the 2018 Code

Taxation and state aid

Simplifying corporate structures

Audit market reform update

Appendix



# Managing risk

This article explores the challenges companies face in dealing with the new requirements to disclose procedures around emerging risks, and examines the dangers in our very human tendency to feel confident in our ability to manage risk, plus we examine the substantial fines that are focusing continued attention on data protection.

## Managing risk in a dynamic environment

Innovations and technologies such as AI and robotics have started to change the risk landscape in which companies operate. New and anticipated regulations pursuant to governmental and international policies around areas of risk such as climate change and data protection also lead to rapid change in the risk landscape. In order to protect and enhance long-term value, companies need to have a dynamic and active approach to risk.

The 2018 UK Corporate Governance Code expects the board to “establish procedures to manage risk, oversee the internal control framework, and determine the nature and extent of the principal risks the company is willing to take in order to achieve its long-term strategic objectives.” (Principle O)

This is supported by provisions requiring ongoing monitoring of the risk management and internal control systems, with a review of their effectiveness at least annually (Provision 29) and a robust assessment of principal and emerging risks (Provision 28). The board is expected to report on both the effectiveness review and on the robust assessment of principal and emerging risks in the annual report.

Understanding principal and emerging risks can also lead to new opportunities to create value for stakeholders, boost performance, and focus on company growth.

## Institute of Internal Auditors report warns of board overconfidence on company capability to handle risks

The Institute of Internal Auditors (IIA) recently published “OnRisk 2020: A Guide to Understanding, Aligning, and Optimizing Risk”. Although focused on an international rather than a UK audience, this guide highlights some significant findings arising from qualitative and quantitative interviews which include areas where UK directors may wish to question whether they are challenging executive management sufficiently.

Risk is, of course, a key part of the role of an audit committee member under the UK Corporate Governance Code. Audit committee members are responsible for bringing an independent mind-set to the role in assessing the work of management. Under the Guidance on Audit Committees, the audit committee should promote “sound risk management and internal control systems... and review these systems... [and] receive reports from management on the effectiveness of the systems they have established”. As non-executive directors, they should “provide constructive challenge, strategic guidance, offer specialist advice and hold management to account.” (2018 Code, Principle H)

The key findings of the IIA report were:

- Boards are overconfident – they assess the organisation to have a greater capability to manage risks than the assessment of executive management.

Economic and political update

Digital – the nine big shifts

The Social Enterprise

Reporting on climate change

Diversity and inclusion

The 2020 Stewardship Code

Managing risk

Internal control and the board

Non-executive pay

The Section 172(1) Statement

FRC reporting messages

Reporting on the 2018 Code

Taxation and state aid

Simplifying corporate structures

Audit market reform update

Appendix



- Boards generally perceive higher levels of maturity in risk management practices – they are more likely to believe that risks are better managed than executive management believes they are.
- There is no such thing as “acceptable misalignment” on the perception of an organisation’s capability to manage a risk.
- Some industries are lagging in adopting systematic approaches to risk.
- Cybersecurity, data and new technology represent critical knowledge deficits for risk management.
- Data and new technology, data ethics, and sustainability risks are expected to grow in relevance over the next five years and organisations can take a proactive approach.
- Talent management and retention are areas at the centre of future concerns, in particular the risk of an inability to attract and retain risk management talent with relevant skills.

### Emerging risks

The FRC spoke about emerging risks in its 2014 Guidance on Risk Management, Internal Control and Related Financial and Business Reporting. It identified the risk management and internal control systems as enabling a company to assess current and emerging risks, respond appropriately to risks and significant control failures and to safeguard the company’s assets. It also called on boards to consider how best to discharge their responsibilities in relation to the existing and emerging principal risks faced by the company and to consider the quality of horizon scanning.

This has been echoed by the changes in the 2018 UK Corporate Governance Code, which calls for boards to carry out a robust assessment of the company’s emerging risks as well as the principal risks. Boards must now also describe what procedures are in place to identify emerging risks.

Nowhere, however, does the FRC define emerging risks. Consensus appears to be emerging over the nature of emerging risks as those characterised by uncertainty. A new definition from the Cambridge Centre for Risk Studies describes an emerging risk as: “a new risk, a changing risk or a novel combination of risks for which the broad impacts, likelihoods and costs are not yet well understood.”

Our Annual Report Insights 2019 survey, which looks at the reporting of 100 companies across the FTSE index, found that although the requirements of the 2018 Code are not yet effective, 21 companies mentioned emerging risks, often linking their comments to the processes described for identifying principal risks. Some of these companies also described certain emerging risks, in particular companies in the banking and insurance industries, although it should be noted that a description is not a requirement of the 2018 Code.

We would expect companies to consider the following features when preparing their disclosures:

- **Make it clear that emerging risks is an area of focus** – this may not always be clear where companies simply add “and emerging risks” to existing disclosure in risk management sections regarding principal risks.
- Consider providing **informative detail** about the nature of the procedures.

Economic and political update

Digital – the nine big shifts

The Social Enterprise

Reporting on climate change

Diversity and inclusion

The 2020 Stewardship Code

Managing risk

Internal control and the board

Non-executive pay

The Section 172(1) Statement

FRC reporting messages

Reporting on the 2018 Code

Taxation and state aid

Simplifying corporate structures

Audit market reform update

Appendix





- **Cross-references** where helpful between risk management section in the strategic report and the audit or risk committee disclosures in the corporate governance statement.

**Questions that boards could usefully be asking to help identify emerging risks include:**

- In which areas is the **business model** vulnerable to disruption?
- What is our exposure to **technology** disruption?
- How could material **environmental & social risks** affect the company's short and long term value?
- What planning is the board doing around emerging areas of **regulatory policy**?
- What are the exposures to **cyber & data security risks** both directly and for key suppliers?
- What are the drivers of **productivity** in the business and how are these managed?
- Do you have a robust set of procedures covering emerging risks that incorporate effective **horizon-scanning** and **triggers** to elevate promptly to the board any risks that emerge and crystallise rapidly?

**Data protection – the Information Commissioner's Office shows its teeth**

One risk cited regularly as an emerging risk has started to crystallise for some companies in the past few months.

During July the ICO published notices of intent to issue monetary penalties to British Airways (£183m) and Marriott (£99m). These are its first significant fines issued since GDPR came into force on 25th May 2018. The GDPR provides the ICO with various enforcement options, including being able to demand that organisations stop processing personal data as well as financial penalties of up to 4% of global turnover.

The ICO has taken the opportunity to demonstrate its intent to enforce high standards by making an example of two very high profile organisations. While the fines issued in the notices of intent are not close to the maximum 4% of global turnover, the size of the figures is very large and has certainly caught the eye of other organisations.

"Personal data has a real value so organisations have a legal duty to ensure its security, just like they would do with any other asset. If that doesn't happen, we will not hesitate to take strong action when necessary to protect the rights of the public."

**Elizabeth Denham, ICO**

Economic and political update

Digital – the nine big shifts

The Social Enterprise

Reporting on climate change

Diversity and inclusion

The 2020 Stewardship Code

Managing risk

Internal control and the board

Non-executive pay

The Section 172(1) Statement

FRC reporting messages

Reporting on the 2018 Code

Taxation and state aid

Simplifying corporate structures

Audit market reform update

Appendix



### Questions on the effectiveness of privacy and cyber programmes

The action by the ICO has been a wake-up call to organisations that had thought GDPR had come and gone, and those that thought the regulator lacked the appetite to exercise the powers it had been given. This will naturally raise questions at a board level of whether Privacy and Cyber programmes are effective enough, and how companies would respond to a regulatory investigation:

- Do we know how thorough our current compliance with GDPR actually is?
- Can we proactively demonstrate compliance?
- Have we continued to embed and improve our processes and controls around personal data since GDPR came into force?
- Do we have a good understanding of where, how and why we process personal data?
- If we do suffer a breach, can we present a robust case to a regulator on our cyber posture before, during and after the breach?

- Have we planned and rehearsed how we would manage a significant breach?
- Is our level of security due diligence appropriate for acquisitions and suppliers?
- Would we be able to cope with a surge in customer enquiries in the event of a breach?

#### Matters for boards to consider

- Are the privacy and cyber programmes mature and the subject of regular updates to the board? Has the board considered where ownership would sit in the case of a significant breach and who would be responsible for ensuring “business as usual”?

Economic and political update

Digital – the nine big shifts

The Social Enterprise

Reporting on climate change

Diversity and inclusion

The 2020 Stewardship Code

Managing risk

Internal control and the board

Non-executive pay

The Section 172(1) Statement

FRC reporting messages

Reporting on the 2018 Code

Taxation and state aid

Simplifying corporate structures

Audit market reform update

Appendix



# Internal control and the board: What is all the fuss about?

The UK Corporate Governance Code already establishes a clear responsibility on the whole board to establish a framework of prudent and effective controls – however, underlying the calls for a US style internal control attestation are very real questions as to whether that responsibility goes far enough and whether there is sufficient guidance for boards, together with sufficiently detailed information from management, to execute this responsibility effectively.

## A reminder of the current UK Corporate Governance Code requirements

**Overarching board responsibility from Code Principle C:** The board should establish a framework of **prudent** and **effective** controls, which enable risk to be assessed and managed.

**Secondary board responsibility from Code Principle O:** The board should establish procedures to manage risk, **oversee the internal control framework**, and determine the nature and extent of the principal risks the company is willing to take in order to achieve its long-term strategic objectives.

**Board activity prescribed by Code Provision 29:** The board should **monitor** the company's 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. The monitoring and review should cover all material controls, including financial, operational and compliance controls.

**Audit committee responsibilities prescribed by Code Provision 25:** **Reviewing** the company's internal financial controls and internal control and risk management systems, unless expressly addressed by a separate board risk committee composed of independent non-executive directors, or by the board itself.

## So what does this mean in practice?

The FRC's Guidance on Risk Management, Internal Control and Related Financial and Business Reporting states that "effective and on-going monitoring and review are essential components of sound systems of risk management and internal control". It recommends the following disclosure:

*The board should summarise the process it has applied in reviewing the effectiveness of the system of risk management and internal control. The board should explain what actions have been or are being taken to remedy any significant failings or weaknesses.*

So in putting together a robust process, the Guidance recommends that, on an ongoing basis, the board should consider:

- how effectively the risks have been assessed and the principal risks determined;
- how the principal risks have been managed or mitigated;
- whether necessary actions are being taken promptly to remedy any significant failings or weaknesses; and

Economic and political update

Digital – the nine big shifts

The Social Enterprise

Reporting on climate change

Diversity and inclusion

The 2020 Stewardship Code

Managing risk

Internal control and the board

Non-executive pay

The Section 172(1) Statement

FRC reporting messages

Reporting on the 2018 Code

Taxation and state aid

Simplifying corporate structures

Audit market reform update

Appendix



- whether the causes of the failing or weakness indicate poor decision-taking, a need for more extensive monitoring or a reassessment of the effectiveness of management's on-going processes.

In addition, the annual review of effectiveness should consider:

- the company's willingness to take on risk (its "risk appetite"), the desired culture within the company and whether this culture has been embedded;
- the operation of the risk management and internal control systems, covering the design, implementation, monitoring and review and identification of risks and determination of those which are principal to the company;
- the integration of risk management and internal controls with considerations of strategy and business model, and with business planning processes;
- the changes in the nature, likelihood and impact of principal risks, and the company's ability to respond to changes in its business and the external environment;
- the extent, frequency and quality of the communication of the results of management's monitoring to the board which enables it to build up a cumulative assessment of the state of control in the company and the effectiveness with which risk is being managed or mitigated;

- issues dealt with in reports reviewed by the board during the year, in particular the incidence of significant control failings or weaknesses that have been identified at any time during the period and the extent to which they have, or could have, resulted in unforeseen impact; and

- the effectiveness of the company's public reporting processes.

The FRC Guidance makes clear that the assessment and processes described above should be used coherently to inform a number of distinct but related disclosures in the annual report and accounts including the statements on longer term viability and the going concern basis of accounting. The purpose of such reporting is to provide information about the company's current position and prospects and the principal risks it faces. It helps to demonstrate the board's stewardship and governance, and encourages shareholders to perform their own stewardship role by engaging in appropriate dialogue with the board and holding the directors to account as necessary. In putting together these disclosures there is a balance to be struck between compliance and also taking the opportunity to provide a more forward-looking and proactive dialogue which can reinforce the robustness of the board's oversight activity and highlight any potential issues which are being actively managed, e.g. in relation to a major IT systems change programme.

A number of respondents to Sir John Kingman's review of the Financial Reporting Council suggested that there was a serious case for considering the introduction of stronger regulation in respect of companies' internal controls, similar to that applying in the USA under the Sarbanes-Oxley Act. BEIS has welcomed this recommendation acknowledging that it is a "detailed and complex issue" and that options need to be explored.

A consultation on those options is expected in Q1 2020.

Economic and political update

Digital – the nine big shifts

The Social Enterprise

Reporting on climate change

Diversity and inclusion

The 2020 Stewardship Code

Managing risk

Internal control and the board

Non-executive pay

The Section 172(1) Statement

FRC reporting messages

Reporting on the 2018 Code

Taxation and state aid

Simplifying corporate structures

Audit market reform update

Appendix



### What requirements does the Sarbanes-Oxley Act place on the various parts of the US governance ecosystem?

In terms of reporting, under the current UK Corporate Governance Code, boards are only required to explain the process for their review of the effectiveness of the risk management and internal control systems rather than comment on the outcome of the review. The Sarbanes-Oxley Act is a much more demanding piece of legislation. Here is a summary of the requirements:

Management	Auditors
<ul style="list-style-type: none"> <li>• Annually assess and report on the effectiveness of the internal controls over financial reporting</li> <li>• Annually assess and report on the effectiveness of disclosure controls and procedures</li> <li>• Disclosure of any material weaknesses in controls that would not prevent or detect a material misstatement in the financial statements</li> <li>• CEO and CFO must certify that they have reviewed the annual or quarterly reports; the financial information included is fairly presented; the report does not contain any untrue statement of material fact or omission that would make the financial statements misleading</li> <li>• CEO and CFO must acknowledge their responsibility for establishing, maintaining and evaluating internal controls over financial reporting plus disclosure controls and procedures</li> <li>• CEO and CFO must certify that each periodic report containing financial statements complies with the US securities laws and fairly presents, in all material respects, the financial condition and results of operations</li> </ul>	<ul style="list-style-type: none"> <li>• Provide a report on the effectiveness of the internal controls over financial reporting (a tiering structure exists so not all entities have this requirement but all large equity listed entities would be covered)</li> <li>• Communications with the audit committee must include a discussion of critical accounting policies and key judgements &amp; estimates used by the company, all alternative accounting treatments that have been discussed with management and the impact of alternative accounting treatments and disclosures</li> </ul>

Economic and political update

Digital – the nine big shifts

The Social Enterprise

Reporting on climate change

Diversity and inclusion

The 2020 Stewardship Code

Managing risk

Internal control and the board

Non-executive pay

The Section 172(1) Statement

FRC reporting messages

Reporting on the 2018 Code

Taxation and state aid

Simplifying corporate structures

Audit market reform update

Appendix



The following types of controls need to be considered as part of the attestation provided by management:

**Entity-level controls** – e.g. the Code of conduct, HR recruitment policies, period-end financial reporting processes.

**Process-level controls** – these can be either manual (e.g. bank reconciliations, inventory counts, review of aged debtors) or automated (e.g. three way match of purchase orders, to invoice, to goods received note).

**General IT controls** – e.g. access controls that restrict the ability of unauthorised users to amend certain records or documents.

#### IT controls – why are they so critical and so challenging to get right?

Your IT environment and the controls over this are the fundamental building block upon which your internal control environment is built. Businesses are ever more reliant upon their IT systems to operate the business, interact with customers and suppliers and produce financial statements.

#### Effective IT controls are critical in ensuring:

##### Security

Ensuring that your systems and data are secure and appropriately protected from the risk of unauthorised access

##### Integrity

Ensuring that your systems are functioning as intended and you can rely on the accuracy and completeness of processing

##### Availability

Ensuring the resilience and redundancy of your environment to support ongoing operation and organisational viability

There are multiple challenges associated with implementing an effective IT control environment:

**Complexity of the IT environment** – is there a good understanding of the IT environment, particularly those systems critical to operations and financial reporting? This can be further complicated by the use of “shadow IT” (systems acquired and supported outside of the core IT function) and outsourcing to third parties, to support and operate your environment.

**Multiple layers of IT** – controls need to be implemented and operated across the multiple layers of the environment, including: the application; the relevant database; and, the underlying operating system.

**Interdependency of controls** – multiple layers of IT controls, operating in tandem, need to be deployed across the environment. For example, the controls to manage a change are only as good as the controls that restrict who can develop that change.

Economic and political update

Digital – the nine big shifts

The Social Enterprise

Reporting on climate change

Diversity and inclusion

The 2020 Stewardship Code

Managing risk

Internal control and the board

Non-executive pay

The Section 172(1) Statement

FRC reporting messages

Reporting on the 2018 Code

Taxation and state aid

Simplifying corporate structures

Audit market reform update

Appendix





### What should boards be doing now?

Notwithstanding the ongoing Government activity which could take the UK in a more prescriptive direction around the board's responsibilities for internal controls, there remains today a responsibility, under the UK Corporate Governance Code, to establish a framework of prudent and effective controls, to oversee that framework and to perform an annual review of effectiveness.

Boards that believe they have a way to go on this journey may wish to start with the following questions:

- Are the risk management and internal control systems appropriate for the company's business model?
- How are authority, responsibility and accountability for risk management and internal control defined, co-ordinated and documented throughout the organisation?
- Has a financial risk assessment been undertaken? What does it tell us?
- Have "material controls" been defined for the business? Where are material risks apparent and decisions taken?
- Can management provide an analysis of material controls by process and central function and provide details around how they are assured?
- Is the company clear about which IT systems are material to financial reporting, operating or compliance controls and have the IT controls been tested?
- At an entity level, has the board considered how the company's culture, code of conduct, human resource policies and performance reward systems support the business objectives and risk management and internal control systems?
- Has management undertaken a fraud risk analysis, including the risk of fraud in financial reporting?
- What are the channels of communication that enable individuals, including third parties, to report concerns, suspected breaches of law or regulations, other improprieties or challenging perspectives?
- How does the board satisfy itself that the information it receives is timely, of good quality, reflects numerous information sources and is fit for purpose?
- Are the papers supporting the board's annual review of effectiveness of internal controls sufficiently comprehensive to support the conclusions, or are the papers more of an "exception report"?
- If the annual review of effectiveness has revealed areas where more needs to be done to enhance material operational, financial or compliance controls, are these areas appropriately disclosed in the annual report?

Economic and political update

Digital – the nine big shifts

The Social Enterprise

Reporting on climate change

Diversity and inclusion

The 2020 Stewardship Code

Managing risk

Internal control and the board

Non-executive pay

The Section 172(1) Statement

FRC reporting messages

Reporting on the 2018 Code

Taxation and state aid

Simplifying corporate structures

Audit market reform update

Appendix





# Remuneration

Economic and political update

Digital – the nine big shifts

The Social Enterprise

Reporting on climate change

Diversity and inclusion

The 2020 Stewardship Code

Managing risk

Internal control and the board

Non-executive pay

The Section 172(1) Statement

FRC reporting messages

Reporting on the 2018 Code

Taxation and state aid

Simplifying corporate structures

Audit market reform update

Appendix



# The non-executive director role – risk, reputation...and reward?

With a significant re-write of the UK Corporate Governance Code and a number of corporate failures in recent years, the expectations and profile of the NED role are shifting. Is remuneration keeping pace?

## The non-executive director role

Headlines around executive director remuneration are commonplace in the UK, and we have seen continued press attention in this area over the past year. In contrast, fees paid to non-executive directors (NEDs) rarely attract media focus, and arguably for good reason. According to our 2019 report, over 50% of FTSE 350 companies made no increase to NED or Chair fees for 2019, with a typical increase of c. 2-2.5% where given.

With a significant re-write of the UK Corporate Governance Code and a number of corporate failures in recent years, the expectations and profile of the NED role are shifting. Expanded responsibilities in areas such as workforce engagement often involve a significantly increased time commitment. The reputational risks for NEDs are more evident than ever - in particular for committee chairs - with a growing prevalence of individuals being called before parliamentary select committees to explain and justify decisions.

In addition to independent oversight of a business, there is a growing focus on the specific skills and expertise of non-executive directors in key areas such as technology, risk, and cybersecurity. Over time, this is expected to lead to greater diversity of boards in areas such as age and economic backgrounds.

In the current pay environment, not surprisingly there is often a reluctance to translate changes in scope and time commitment into fees. While pay may not be a primary driver for NEDs with a background of long executive tenure, recent events bring to light the importance of attracting a high calibre of diverse and experienced talent to oversee the UK's largest listed companies, in an increasingly complex business landscape.

*“Non-executive directors should have sufficient time to meet their board responsibilities. They should provide **constructive challenge, strategic guidance, offer specialist advice** and hold management to account”*

### Principle H, 2018 Code

*“Non-executive directors [...] should consider ways of reaching out to increase their visibility with the workforce and gain insights into the culture and concerns at different levels of the business. **This is likely to involve spending more time in the business.**”*

### Guidance on Board Effectiveness, 2018 Code

*“We may recommend voting against the chair of the nomination committee if a board has not addressed major issues of board composition, including the **composition, mix of skills, and experience of the non-executive element of the board.**”*

### Glass Lewis 2020 proxy guidelines

Economic and political update

Digital – the nine big shifts

The Social Enterprise

Reporting on climate change

Diversity and inclusion

The 2020 Stewardship Code

Managing risk

Internal control and the board

Non-executive pay

The Section 172(1) Statement

FRC reporting messages

Reporting on the 2018 Code

Taxation and state aid

Simplifying corporate structures

Audit market reform update

Appendix



### NED fees

The UK Corporate Governance Code states that ‘levels of remuneration for ... all non-executive directors should reflect the time commitment and responsibilities of the role’. In the majority of companies, a basic fee is paid to non-executive directors, typically with additional fees to the senior independent director, and the chair of the audit and remuneration committee. In the largest companies, it is common to pay a separate committee membership fee.<sup>2</sup> While NED fee levels may be reviewed every 2-3 years, this does not typically result in an increase, as shown below.

#### Fee increases in 2019 so far (non-executive directors) – FTSE 350

% of companies	FTSE 100	FTSE 250
Zero increase	56%	53%
1-5% increase	31%	31%
5-10% increase	7%	11%
Over 10% increase	6%	5%

% of increase	FTSE 100	FTSE 250
Upper quartile	2.5%	2.5%
Median	0%	0%
Lower quartile	0%	0%

The median basic fee paid to a FTSE 100 NED has risen from £60,000 in 2010 to £70,000 in 2019. In FTSE 250 and Small Cap companies, the median basic fee has increased at a slightly higher rate, from £40,000 in 2010 to £55,000 in 2019 in the FTSE 250, recognising the greater involvement of non-executives in these markets, as investors and regulators increasingly hold all companies to the same standards of governance and engagement.

However, in the context of a rapidly changing governance landscape and with a heightened profile of board directors, we have seen the time commitment required of NEDs significantly increase – in particular in relation to the committee chair role – with a number of NEDs now asking “is it worth it?”.

#### Committee chair fees

The median additional fee for chairing a FTSE 100 audit committee is £21,000 in 2019, compared to £20,000 ten years ago. The FTSE 100 remuneration committee chair fee has increased to £20,000 from £15,000 in 2010, recognising the rising complexity of UK pay governance and regulation.

Economic and political update

Digital – the nine big shifts

The Social Enterprise

Reporting on climate change

Diversity and inclusion

The 2020 Stewardship Code

Managing risk

Internal control and the board

Non-executive pay

The Section 172(1) Statement

FRC reporting messages

Reporting on the 2018 Code

Taxation and state aid

Simplifying corporate structures

Audit market reform update

Appendix

1 Deloitte report on Directors’ Remuneration in FTSE 100 and FTSE 250 companies, October 2019.

2 73% of Top 30 companies pay a separate fee for committee membership, compared to 30% in FTSE31-100. 23% of the FTSE 250 pay a separate fee for committee membership.



However, increasingly we see committee chairs question whether a typical fee premium of c.25% (or less where a committee membership fee is paid) continues to be commensurate with the growing demands of the role, where the time commitment in areas such as shareholder engagement on executive pay or financial reporting reviews can be substantial, and reputational risks are high.

#### The 'modern' RemCo chair

Typical responsibilities include:

- Engagement with up to 30 shareholders in a policy year.
- Overseeing pay decisions around 'hiring and firing'
- Managing potential conflicts between executive and remuneration committee members' views on pay
- Review of workforce pay and conditions, and involvement in diversity initiatives such as gender pay
- Liaison with company secretary and Head of Reward on the content of committee papers and approaches to new governance and regulatory requirements
- Oversee agenda and sign off papers for RemCo meetings
- Preparation for and attendance at 4-6 RemCo meetings and AGM, including adviser meetings

#### The 'modern' AuditCo chair

Typical responsibilities include:

- Regular engagement with the external auditor, incl. on scope of the audit, audit reports, independence matters
- Leading any external audit tender process
- Regular engagement with the head of internal audit, incl. scope of the internal audit plan
- Liaison with company secretary, treasury, finance and tax and briefings on regulatory changes
- Oversight of the effectiveness of the risk management and internal control systems
- Detailed review of annual report, interim report and other price-sensitive public records and reports to regulators
- Oversee agenda and sign off papers for AuditCo meetings
- Preparation for and attendance at 4+ AuditCo meetings and AGM

Economic and political update

Digital – the nine big shifts

The Social Enterprise

Reporting on climate change

Diversity and inclusion

The 2020 Stewardship Code

Managing risk

Internal control and the board

Non-executive pay

The Section 172(1) Statement

FRC reporting messages

Reporting on the 2018 Code

Taxation and state aid

Simplifying corporate structures

Audit market reform update

Appendix



As shown in the table, we have seen companies more proactively recognise the increased scope of committee chair roles in the financial services sector, following substantial regulatory change in recent years. The median additional fee for a FTSE 100 audit or committee chair is £30,000 in the FS market, with the UK's largest banks paying additional fees of £70,000 - £75,000 for these roles.

Additional committee fees (median fee)	FTSE 100	FTSE 100 Financial services	FTSE 250	FTSE 250 Financial services
Audit Committee chair	<b>£21,000</b>	£30,000	<b>£11,000</b>	£20,000
Remuneration Committee chair	<b>£20,000</b>	£30,000	<b>£11,000</b>	£20,000
Audit committee membership (where paid)	£15,000 (45% pay membership fee)	-	£6,000 (23% pay membership fee)	-
Remuneration Committee membership (where paid)	£15,000 (44% pay membership fee)	-	£5,000 (23% pay membership fee)	-

Under the UK Corporate Governance Code, “remuneration for all NEDs should not include share options or other performance-related elements”, although they are often encouraged to own shares in the company. This contrasts to US practice where, in addition to a cash fee structure, an equity award is also typically made to NEDs, commonly in the form of share options or restricted shares.

### Other fees

A significant change to the UK Corporate Governance Code is the requirement to formalise a workforce engagement mechanism, with many companies appointing a ‘designated non-executive director’.

As companies begin to explore how this will be implemented in practice, it is expected that the designated NED role will involve an additional commitment of time of at least 4 – 5 days, potentially much more in the case of a large and global workforce. To date, the majority of companies have not yet agreed and disclosed additional fee to be paid, with many showing a reluctance to be a ‘first mover’ in this area. Where fees have been paid, they range from £3,000 to £20,000, and we expect many more companies to disclose additional fees for this role in the coming year.

Economic and political update

Digital – the nine big shifts

The Social Enterprise

Reporting on climate change

Diversity and inclusion

The 2020 Stewardship Code

Managing risk

Internal control and the board

Non-executive pay

The Section 172(1) Statement

FRC reporting messages

Reporting on the 2018 Code

Taxation and state aid

Simplifying corporate structures

Audit market reform update

Appendix



### Risk, reputation...and reward?

The 'typical' NED is changing. In a more diverse talent market, non-executive directors may no longer hold a background of a lengthy executive tenure, but include those building a portfolio career, or holding specific skills and experience in areas such as technology and risk.

With a growing pressure around 'over-boarding' and limiting the number of directorships taken, in our view companies must ensure that the increased time commitment often required of UK NEDs is recognised and fairly rewarded, to ensure they are able to attract the calibre and diversity of skillsets needed to oversee UK listed companies. This may mean making bolder decisions around non-executive pay.

#### Key takeaways

- Expectations and profile of the NED role are shifting, with increasing time commitments linked to governance changes, in particular for audit and remuneration committee chairs.
- With growing pressure around 'overboarding', boards should ensure time commitment is recognised and fairly rewarded, to ensure UK listed companies are able to attract the calibre and diversity of talent needed to oversee companies.

#### Contacts – Executive compensation

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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Economic and political update

Digital – the nine big shifts

The Social Enterprise

Reporting on climate change

Diversity and inclusion

The 2020 Stewardship Code

Managing risk

Internal control and the board

Non-executive pay

The Section 172(1) Statement

FRC reporting messages

Reporting on the 2018 Code

Taxation and state aid

Simplifying corporate structures

Audit market reform update

Appendix



# *Year-end reporting & assurance update*

Economic and political update

Digital – the nine big shifts

The Social Enterprise

Reporting on climate change

Diversity and inclusion

The 2020 Stewardship Code

Managing risk

Internal control and the board

Non-executive pay

The Section 172(1) Statement

FRC reporting messages

Reporting on the 2018 Code

Taxation and state aid

Simplifying corporate structures

Audit market reform update

Appendix



# The Section 172(1) statement – getting it right

This reporting season directors of qualifying companies will be publishing, for the first time, a section 172(1) statement. This statement is intended to be an articulation of how they, as directors, have met their duty under the Companies Act. This article sets out a high level summary of what to look out for and how to develop a meaningful depiction of the board's section 172 activities in an already busy annual report.

## A reminder of the new reporting requirement

### s414CZA(1) – Section 172(1) statement

A strategic report for a financial year of a company must include a statement which describes how the directors have had regard to the matters set out in section 172(1) (a) to (f) when performing their duty under section 172.

**Scope:** all UK companies qualifying as large under the Companies Act 2006

The recent [FRC letter to Audit Committee Chairs and Finance Directors](#) (for further detail on other aspects of that letter see the article 'Key messages for 2019/2020 reporting season annual reports') reiterated the expectations set out in the **BEIS FAQs** which were issued at the same time as the [Miscellaneous Reporting Regulations](#). These stated that depending on the individual circumstances, companies will probably want to include information on some or all of the following:

- the issues, factors and stakeholders the directors consider relevant in complying with section 172(1) (a) to (f) and how they have formed that opinion;

- the main methods the directors have used to engage with stakeholders and understand the issues to which they must have regard; and
- information on the effect of that regard on the company's decisions and strategies during the financial year. Companies will need to judge what is appropriate, but the statement should be meaningful and informative for shareholders, shed light on matters that are of strategic importance to the company and be consistent with the size and complexity of the business.



Please refer to our **'Board briefing on the new Section 172(1) statement'** for a deeper dive on the elements to consider when putting together an authentic statement. This includes our suggested structure for the statement and also a number of questions which companies may wish to consider when assessing the impact of engagement activities.

Economic and political update

Digital – the nine big shifts

The Social Enterprise

Reporting on climate change

Diversity and inclusion

The 2020 Stewardship Code

Managing risk

Internal control and the board

Non-executive pay

The Section 172(1) Statement

FRC reporting messages

Reporting on the 2018 Code

Taxation and state aid

Simplifying corporate structures

Audit market reform update

Appendix





### Checklist for directors when reviewing the section 172(1) statement

Here is our ten-point checklist to help you when you are reviewing the section 172(1) statement for the first time this year:

1. Is the statement included in the Strategic Report?
2. Is the statement separately identifiable?
3. Does it explain the issues, factors and stakeholders which you, the directors, have considered relevant in complying with your section 172 duty? Does the statement explain how the board came to that view on relevance?
4. How consistent is the list of relevant issues, factors and stakeholders to the existing disclosures of key dependencies (resources and relationships) in the business model section of the annual report?
5. For each relevant stakeholder, is the statement cross-referencing to appropriate and meaningful existing annual report disclosures which describe the engagement mechanisms used to understand the issues to which the directors should have regard? (see next table for likely relevant disclosures)
6. Is it made clear in the statement how the board uses the output of that engagement in the board decision-making process?
7. Does the statement include specific examples which demonstrate the effect of that regard on the company's decisions and strategies during the financial year?
8. How well do the examples provided align to key events which took place during the year? The CEO and CFO statements are likely to be good reference points for key events.
9. Is the statement reflective of and consistent with the size and complexity of the business?
10. Overall, are you, as a director, comfortable that the statement accurately captures the considerations taken into account by the board when making decisions during the year?

In designing their statements, directors will be well aware that there is already relevant information elsewhere in the annual report - meaning that a decision needs to be taken early about how best to draw these elements together, perhaps through cross-reference, and how to provide the additional insights into board decision-making.

Section 172 factor	Example of relevant existing disclosure
<b>The long-term</b>	<ul style="list-style-type: none"> <li>• Company purpose</li> <li>• Business model</li> <li>• Strategy</li> <li>• Capital allocation &amp; dividend policy</li> </ul>
<b>Employees</b>	<ul style="list-style-type: none"> <li>• Business model – talent aspects</li> <li>• People section of a CSR report</li> <li>• Diversity &amp; Inclusion</li> <li>• Non-financial information statement</li> <li>• Corporate governance section on the workforce engagement mechanism</li> </ul>
<b>Business relationships – suppliers, customers</b>	<ul style="list-style-type: none"> <li>• Business model – key business relationship aspects</li> <li>• Anti-bribery and anti-corruption disclosures</li> <li>• Modern Slavery statement (where included in the annual report)</li> </ul>
<b>Community &amp; environment</b>	<ul style="list-style-type: none"> <li>• CSR report – community &amp; environment aspects</li> <li>• Non-financial information statement</li> <li>• Any TCFD framework disclosures</li> </ul>
<b>High standards of business conduct</b>	<ul style="list-style-type: none"> <li>• Culture</li> <li>• Ethics and values</li> <li>• Corporate governance statement</li> </ul>
<b>Shareholders</b>	<ul style="list-style-type: none"> <li>• Corporate governance statement</li> </ul>

Economic and political update

Digital – the nine big shifts

The Social Enterprise

Reporting on climate change

Diversity and inclusion

The 2020 Stewardship Code

Managing risk

Internal control and the board

Non-executive pay

The Section 172(1) Statement

FRC reporting messages

Reporting on the 2018 Code

Taxation and state aid

Simplifying corporate structures

Audit market reform update

Appendix



# Key messages for 2019/2020 reporting season annual reports

In this article we look at the key messages from the FRC's Corporate Reporting Review Team regarding 2019/2020 annual reports, together with some insights on stakeholder perceptions of non-financial reporting.



The FRC has issued its [Annual Review of Corporate Reporting 2018/19](#) and its [annual letter](#) to finance directors and audit committee chairs covering its perspective on key areas of focus for 2019/20 annual reports. The document is much more detailed than in prior periods – this and the tone leave no doubt over the messaging.

## Strategic report

The FRC reminds preparers that the strategic report provides an opportunity to provide users with a holistic narrative explaining and supplementing key information in their financial statements.

- *Non-financial information statement* - The statement should be separately identifiable but can cross-refer to where the required disclosures are provided within the strategic report. These should include a clear description of the company's policies, any due diligence processes implemented in pursuance of those policies and their outcomes in respect of environmental, social, anti-corruption and anti-bribery matters, employees and respect for human rights. Later in this article we include some key findings of the recent BEIS report on stakeholder perceptions of non-financial reporting.

- *Section 172 report* – Annual reports for December 2019 and subsequent year ends are required to include a further statement within their strategic report, describing how boards have had regard to the factors laid out in section 172 of the Companies Act when working to promote the success of the business. See article *The Section 172(1) Statement* for further information.

## Environmental disclosures, including reporting on climate change

In July, the Government published its [Green Finance Strategy](#) which sets the direction for climate change regulation and action: large asset owners and listed companies are expected to report in accordance with the requirements of the Task Force on Climate-Related Financial Disclosures (“TCFD”) by 2022.

We examine current developments in climate change reporting, including the report published by the FRC's Financial Reporting Lab, in the article [Reporting on climate change](#).

Economic and political update

Digital – the nine big shifts

The Social Enterprise

Reporting on climate change

Diversity and inclusion

The 2020 Stewardship Code

Managing risk

Internal control and the board

Non-executive pay

The Section 172(1) Statement

FRC reporting messages

Reporting on the 2018 Code

Taxation and state aid

Simplifying corporate structures

Audit market reform update

Appendix



Other topical areas of reporting for attention

Area of focus	Description
<b>Critical judgements and estimates</b>	<ul style="list-style-type: none"> <li>• More companies this year made a clear distinction between judgements and estimates. However the following points should be considered:                             <ul style="list-style-type: none"> <li>– sufficient disclosure where a particular judgement has significant impact on the reporting, for example, whether a specific investment should be consolidated;</li> <li>– clear disclosure of the sensitivity of carrying amounts to the assumptions and estimates underlying a measurement calculation, or, if more meaningful, disclosure of the range of reasonably possible outcomes within the next year in respect of the carrying amounts of the relevant assets and liabilities; and</li> <li>– voluntary, additional disclosures to be provided in respect of estimation uncertainty, for example, where the impact of any possible material change in estimate is not anticipated to have effect until a period outside the twelve-month window required by the standard.</li> </ul> </li> </ul>
<b>2019 year-end reporting environment and going concern</b>	<ul style="list-style-type: none"> <li>• Companies are expected to consider carefully the details provided in those areas of the reports which are exposed to heightened levels of risk; for example, going concern considerations and the impact of Brexit.</li> <li>• Although not covered in the letter, audit committees should bear in mind the “significantly stronger requirements for UK auditors” under the updated going concern standard for auditors, applicable for periods commencing on or after 15 December 2019, with earlier adoption permitted. This will require more focus from the auditor on the adequacy of management’s assessment and going concern papers and a positive statement in the audit report that the going concern basis is appropriate.</li> </ul>
<b>Reforms of interest rate benchmarks</b>	<ul style="list-style-type: none"> <li>• The recent amendments to IFRS 9 Financial Instruments and IAS 39 Financial Instruments: Recognition and Measurement impact this season’s year-end reporting and reflect global reforms of interest rate benchmarks, such as LIBOR. The future of a number of these benchmarks beyond 2021 is not clear:                             <ul style="list-style-type: none"> <li>– boards must reach their own judgement as to whether the level of this uncertainty is so high that the conditions for hedge accounting are not met; and</li> <li>– companies which are a party to contracts referencing LIBOR, or any other rate subject to the reforms, should start planning now for the transition to new rates, including early consideration of the need to re-negotiate relevant contracts and agreements.</li> </ul> </li> </ul>

- Economic and political update
- Digital – the nine big shifts
- The Social Enterprise
- Reporting on climate change
- Diversity and inclusion
- The 2020 Stewardship Code
- Managing risk
- Internal control and the board
- Non-executive pay
- The Section 172(1) Statement
- FRC reporting messages
- Reporting on the 2018 Code
- Taxation and state aid
- Simplifying corporate structures
- Audit market reform update
- Appendix



### Other topical areas of reporting for attention

Area of focus	Description
<b>Cash Flow Statements</b>	<ul style="list-style-type: none"> <li>• In order to improve the reliability of cash flow reporting companies should:                             <ul style="list-style-type: none"> <li>– follow the detailed requirements of IAS 7 Statement of Cash Flows and ensure robust pre-issuance review in order to avoid basic errors, in particular, misclassification of cash flows which is evident from the face of the financial statements; and</li> <li>– disclose and explain where a genuine material judgement has been made regarding cash flow presentation.</li> </ul> </li> </ul>
<b>Supplier financing arrangements</b>	<ul style="list-style-type: none"> <li>• There remain concerns about the level of disclosure around supplier financing arrangements. Companies should disclose whether and, if so, the extent to which, they enter into this type of arrangement. Clear disclosure of debt financing and factoring is also critical to the annual report. Some details about the FRC Financial Reporting Lab report, Disclosures on the sources and uses of cash, are included later in this article.</li> <li>• Companies are encouraged to disclose explicitly that they don't use such arrangements in industries where their usage is more common.</li> </ul>
<b>Alternative performance measures ("APMs")</b>	<ul style="list-style-type: none"> <li>• All companies that report APMs should apply the <a href="#">Guidelines</a> produced by ESMA. In particular:                             <ul style="list-style-type: none"> <li>– explanation and meaningful definition of APMs; and</li> <li>– reconciliation to the closest equivalent IFRS line item.</li> </ul> </li> </ul>
<b>Impairment of non-financial assets</b>	<ul style="list-style-type: none"> <li>• In relation to the impairment of non-financial assets, the following expectations have been set:                             <ul style="list-style-type: none"> <li>– clearly identify and quantify the key assumptions used in the cash flow projections, not just the discount and long-term growth rates;</li> <li>– explain the process by which the board determined those key assumptions;</li> <li>– describe the changes in key assumptions that management thinks reasonably possible and the impact of these changes if they would reduce headroom to nil or give rise to potential material adjustment to its carrying value; and</li> <li>– perform an impairment review where a parent company's investment in subsidiaries exceeds the market capitalisation of the group.</li> </ul> </li> </ul>

Economic and political update

Digital – the nine big shifts

The Social Enterprise

Reporting on climate change

Diversity and inclusion

The 2020 Stewardship Code

Managing risk

Internal control and the board

Non-executive pay

The Section 172(1) Statement

FRC reporting messages

Reporting on the 2018 Code

Taxation and state aid

Simplifying corporate structures

Audit market reform update

Appendix



Other topical areas of reporting for attention

Area of focus	Description
<p><b>IFRS 15 Revenue from Contracts with Customers</b></p>	<ul style="list-style-type: none"> <li>• All companies should seek to benchmark the quality of disclosures and focus on greater clarity and transparency by addressing the following expectations:                             <ul style="list-style-type: none"> <li>– the accounting policy should identify the specific nature of performance obligations and explain the point at which they are satisfied;</li> <li>– the accounting policy should clearly set out when revenue is recognised in respect of all material revenue streams;</li> <li>– specific judgements which have a significant impact on the amount or timing of revenue recognition should be disclosed;</li> <li>– estimation uncertainties relating to revenue should be quantified, and provide sensitivities or ranges of outcomes; and</li> <li>– significant movements in contract assets and liabilities should be explained.</li> </ul> </li> </ul>
<p><b>IFRS 9 Financial Instruments</b></p>	<ul style="list-style-type: none"> <li>• Banks are expected to:                             <ul style="list-style-type: none"> <li>– adequately explain the triggers for any significant increase in credit risk and default; and</li> <li>– when considering forward looking information, quantify the most significant economic assumptions.</li> </ul> </li> <li>• Non-banking companies are expected to:                             <ul style="list-style-type: none"> <li>– ensure that the description of the business model adequately explains and supports the hold to collect model when the company holds financial assets to collect their contractual cash flows, rather than with a view to selling the assets to generate cash flows;</li> <li>– remove all old IAS 39 Financial Instruments: Recognition and Measurement terminology from the disclosures;</li> <li>– ensure that accounts reflect the fact that the scope of the impairment requirements includes, for example, IFRS 15 contract assets, lease receivables and also applies to loans to subsidiaries and other undertakings in the individual parent company accounts; and</li> <li>– if relevant, explain why the impact of IFRS 9 Financial Instruments is not material, particularly where significant financial instruments are recognised in the accounts.</li> </ul> </li> </ul>

Economic and political update

Digital – the nine big shifts

The Social Enterprise

Reporting on climate change

Diversity and inclusion

The 2020 Stewardship Code

Managing risk

Internal control and the board

Non-executive pay

The Section 172(1) Statement

FRC reporting messages

Reporting on the 2018 Code

Taxation and state aid

Simplifying corporate structures

Audit market reform update

Appendix



Area of focus	Description
<b>IFRS 16 Leases</b>	<ul style="list-style-type: none"> <li>• As IFRS 16 is effective for periods beginning on or after 1 January 2019, companies are required to provide:                             <ul style="list-style-type: none"> <li>– clear explanation of the key judgements made in response to the new reporting requirements;</li> <li>– effective communication of the impact on profit and loss, addressing any lack of comparability with the prior year;</li> <li>– clear identification of practical expedients used on transition and accounting policy choices; and</li> <li>– well explained reconciliation, where necessary, of operating lease commitments under the previous leasing standard and lease liabilities under IFRS 16.</li> </ul> </li> </ul>

**Other topical areas of reporting for attention**

Unlike the prior year, this Annual Review does not include observations on the quality of corporate governance reporting. The FRC explains that this year it undertook an assessment of early adoption of the 2018 UK Corporate Governance Code and also reporting on the 2016 Code. It will publish findings and its expectations for the 2019/20 reporting season later this year.

- Economic and political update
- Digital – the nine big shifts
- The Social Enterprise
- Reporting on climate change
- Diversity and inclusion
- The 2020 Stewardship Code
- Managing risk
- Internal control and the board
- Non-executive pay
- The Section 172(1) Statement
- FRC reporting messages
- Reporting on the 2018 Code
- Taxation and state aid
- Simplifying corporate structures
- Audit market reform update
- Appendix



### FRC's Financial Reporting Lab report – Disclosures on the sources and uses of cash

In September 2019, the FRC's Financial Reporting Lab ("the Lab") published a report, [Disclosures on the sources and uses of cash](#).

The Lab identified four key questions that investors want to answer:

1. How much cash is being generated from the operations of the business, both in the current period and future?
2. Is generated cash likely to be sufficient to meet the company's strategic objective and, if not, where will the required cash come from?
3. What is the company planning to do with the cash it generates, especially beyond servicing its current operations?
4. Is management being effective and efficient in its use of cash?

The report includes the diagram below which helpfully illustrates how cash disclosures in the annual report can set about answering these key questions.

#### Closing Out 2019

is a one-stop guide which covers the principal narrative and financial reporting issues that are relevant to annual reports for the 2019 reporting season. As well as highlighting key areas of regulatory focus identified in the FRC's Annual Review of Corporate Reporting and ESMA's common enforcement priorities, the 2019 guide considers other aspects of reporting, including the new requirement to prepare a 'section 172(1) statement' and the increasing focus on discussion of climate change and dividend policy.

#### Matters for boards to consider

- Is the board confident in the quality and content of the strategic report and how the new requirements of the section 172(1) statement have been met? Does the strategic report make it easy for a reader to understand the sources and uses of cash?
- Does the annual report clearly describe the judgements and estimates and provide enough information for the reader to have a good understanding of how each of these may change over the coming year?
- Has enough information been brought to the board / audit committee and reflected in the annual report regarding the implementation of new accounting standards, in particular IFRS 16?

Economic and political update

Digital – the nine big shifts

The Social Enterprise

Reporting on climate change

Diversity and inclusion

The 2020 Stewardship Code

Managing risk

Internal control and the board

Non-executive pay

The Section 172(1) Statement

FRC reporting messages

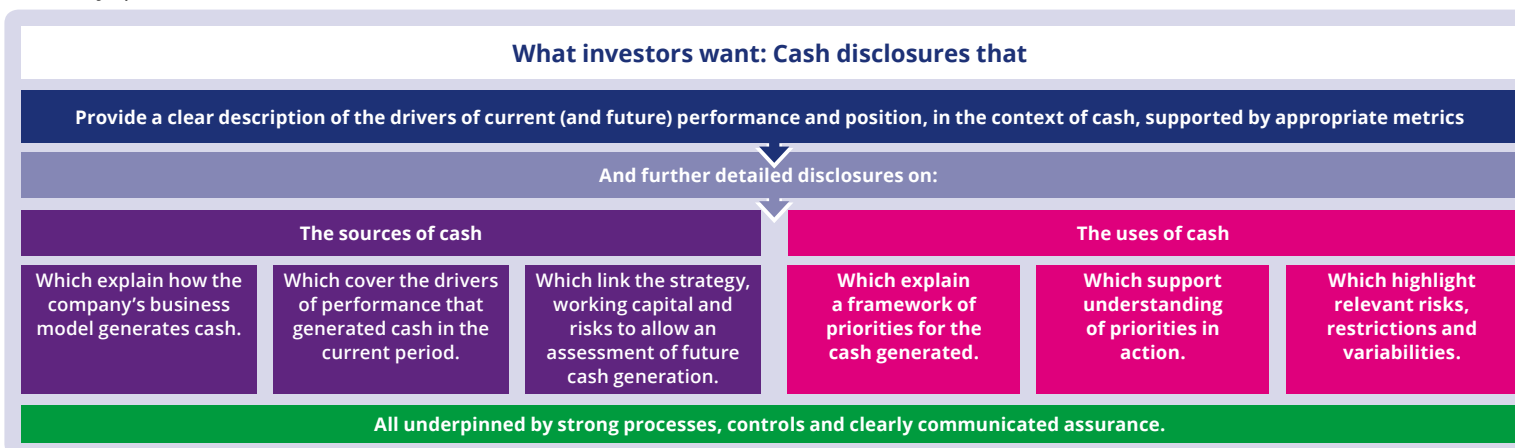
Reporting on the 2018 Code

Taxation and state aid

Simplifying corporate structures

Audit market reform update

Appendix



# The new UK Corporate Governance Code – focusing on activities and outcomes

In this article we provide a timely reminder of the new disclosure elements of the 2018 UK Corporate Governance Code which applies for the first time to calendar 2019 year ends. We examine the clear expectations for the corporate governance section this reporting season, particularly important given that the FRC has stated that it will be reviewing corporate governance sections of annual reports for the first time.

The [2018 UK Corporate Governance Code](#) came into force from 1 January 2019, and is a very different Code from previous versions, with new content and a completely new referencing system. It will not be appropriate to simply roll forward last year's governance section as considerable thought will be required to meet the new requirements and to report meaningfully on the activities undertaken and the outcomes achieved.

It is worth a quick reminder of the specific Listing Rule requirements in relation to corporate governance. There are two distinct parts called for in the annual report:

1. A statement of how the listed company has **applied the principles** set out in the UK Corporate Governance Code, in a manner that would enable shareholders to evaluate how the principles have been applied.
2. A statement as to whether the listed company has **complied throughout the accounting period with all relevant provisions** set out in the UK Corporate Governance Code.

The key new disclosure areas to watch out for as you describe the activities the board has undertaken to implement the new Code during the year are as follows:

<b>Contribution to wider society</b>	Acknowledge this additional element of the board's role in measuring success as set out in Principle A.
<b>Company purpose</b>	Connect the purpose statement at the start of the annual report to the governance statement to make clear the board's role in establishing company purpose and also in alignment between purpose, values, strategy and culture. (Principle B)
<b>Governance arrangements contribution to strategy</b>	The Chairman's introduction to the governance statement could make reference to how the governance arrangements described in that section support and contribute to the delivery of strategy. (Provision 1)

Economic and political update

Digital – the nine big shifts

The Social Enterprise

Reporting on climate change

Diversity and inclusion

The 2020 Stewardship Code

Managing risk

Internal control and the board

Non-executive pay

The Section 172(1) Statement

FRC reporting messages

Reporting on the 2018 Code

Taxation and state aid

Simplifying corporate structures

Audit market reform update

Appendix





<b>Assessing and monitoring corporate culture</b>	Provide a description of the mechanisms in place for the board to assess and monitor culture and any outcomes or corrective actions taken. (Provision 2)
<b>Workforce policies &amp; practices</b>	Describe the group's approach to investing in and rewarding its workforce and be clear on how the company's "workforce" is defined. (Provision 2)
<b>Workforce engagement</b>	Describe which of the three workforce engagement mechanisms has been determined to be the most appropriate and effective for the company (if any) and why. If an alternative mechanism has been adopted provide a clear description and explain why this approach is deemed to be effective. The aim here is to make sure there is appropriate visibility of this engagement in the boardroom. We know that the FRC is keen to see evidence of impact and outcomes. (Provision 5)
<b>Whistleblowing</b>	Whistleblowing has been elevated to a whole board responsibility covering any concerns (in other words a broader "speak up" process) rather than being an audit committee responsibility with a focus on financial matters. Consider whether there is a need to enhance existing disclosures to make this clear. (Provision 6)
<b>Independence of NEDs</b>	Consider whether any of the NEDs' independence may appear impaired and whether there is an appropriately clear explanation of the board's conclusion in this respect. (Provision 10)
<b>Succession planning</b>	Review existing disclosure of succession planning procedures and policies to determine whether they are sufficiently robust and cover both the board and senior management pipeline, including diversity. (Principle J)
<b>Maximum tenure of the chair</b>	Consider whether the tenure of the chair exceeds (or is close to exceeding) the new nine year maximum set by the Code and needs to be explained/justified. (Principle 19)
<b>Board effectiveness review</b>	Where there has been an external review undertaken in the year, is it clear what the nature and extent of the external evaluator's contact with the board and individual directors was and whether there was any impact on board composition. (Provision 23)
<b>Diversity</b>	If not already provided elsewhere in the annual report, the new Code calls for detail of the policy on diversity and inclusion and a breakdown of the gender split of the direct reports to the senior management team. (Provision 23)
<b>Internal assurance</b>	Where there is no internal audit function, the audit committee will need to explain how internal assurance is achieved. (Provision 26)
<b>Emerging risks</b>	Review the existing disclosures on risk identification and assessment activities and decide to what extent there is sufficient explanation of the board's procedures on emerging risks/horizon scanning. (Provision 28)

Economic and political update

Digital – the nine big shifts

The Social Enterprise

Reporting on climate change

Diversity and inclusion

The 2020 Stewardship Code

Managing risk

Internal control and the board

Non-executive pay

The Section 172(1) Statement

FRC reporting messages

Reporting on the 2018 Code

Taxation and state aid

Simplifying corporate structures

Audit market reform update

Appendix



## Remuneration

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. (Provision 41)

The FRC has announced that it will be reviewing the corporate governance section of annual reports for the first time in 2020. In our discussions with them, the FRC has made clear that they will be looking for a clear focus on the **outcomes** of new governance arrangements in addition to the brief description of the policies and practices adopted. The FRC is due to set out further expectations in relation to reporting on the new Code by the end of the year.

### Matters for boards to consider

- Is it clear that the corporate governance section of the annual report is addressing the 2018 UK Corporate Governance Code?
- Does the corporate governance section clearly explain how the principles of the Code have been applied in addition to confirming the level of compliance with the Code provisions?
- Is there discussion of activities and outcomes in the year in addition to description of policies and processes?
- A final housekeeping point: Is the board confident that key governance documents, e.g. terms of reference, delegated authorities etc, have been updated to reflect the new Code and the disclosures provided in the annual report?

Economic and political update

Digital – the nine big shifts

The Social Enterprise

Reporting on climate change

Diversity and inclusion

The 2020 Stewardship Code

Managing risk

Internal control and the board

Non-executive pay

The Section 172(1) Statement

FRC reporting messages

Reporting on the 2018 Code

Taxation and state aid

Simplifying corporate structures

Audit market reform update

Appendix



# Taxation and state aid

This article explores the challenges companies face in dealing with the issues regarding the European Union's state aid position, determining whether a provision is necessary and the audit committee's conclusions on the quality of disclosure.

## Background

In October 2017 the European Commission (EC) opened an in-depth investigation into the so-called Finance Company exemption in the UK's CFC rules. This exemption effectively permits only one quarter of certain intra-group interest income to be taxed under UK CFC rules, as opposed to a full inclusion which would otherwise arise.

The EC concluded that the Finance Company partial exemption was justified to a degree. However, to the extent that "significant people functions" relating to the financing structure were performed in the UK, the exemption represents illegal state aid, because the finance income attributable to those significant people functions should have been taxed in the UK.

The EC's final decision, concluding that the legislation up until December 2018 did partially represent state aid, was published in April 2019.

## Current status and considerations for directors

HMRC has been tasked with collecting the deemed underpaid tax plus compound interest that should have arisen had this partial exemption not been available. HMRC appealed the EC's decision in July 2019.

Numerous major UK PLCs have made disclosures in their financial statements indicating that they benefited from the exemption and thus faced the risk of receiving a demand to repay the financial benefit in the event of a negative decision from the EC. Some of these companies have also separately appealed against the EC's decision.

In total, HMRC anticipates that around 200 companies are affected and has written to those companies seeking to gather relevant information.

Economic and political update

Digital – the nine big shifts

The Social Enterprise

Reporting on climate change

Diversity and inclusion

The 2020 Stewardship Code

Managing risk

Internal control and the board

Non-executive pay

The Section 172(1) Statement

FRC reporting messages

Reporting on the 2018 Code

Taxation and state aid

Simplifying corporate structures

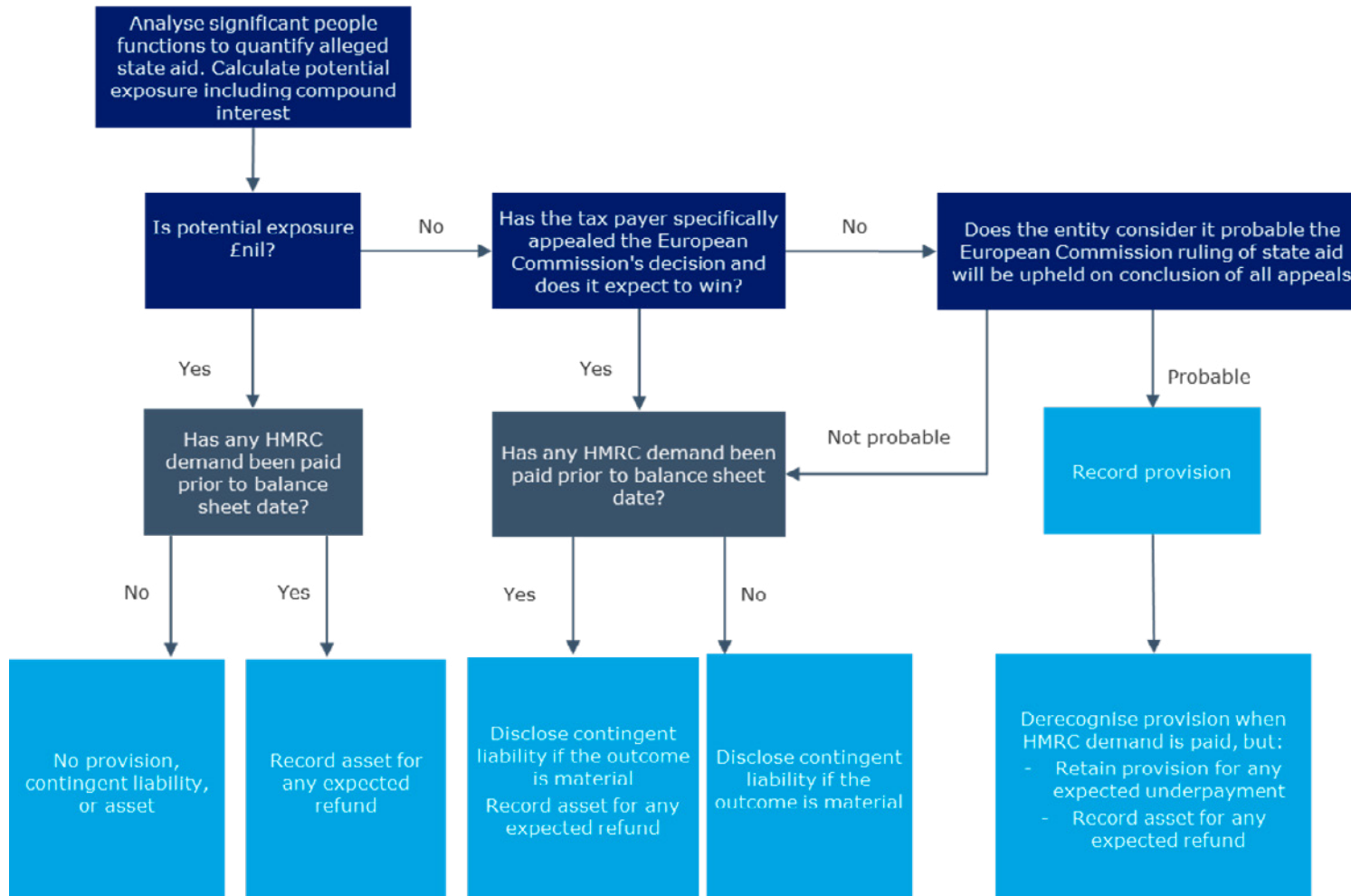
Audit market reform update

Appendix



**How will executive management make their decisions?**

The diagram below shows the decision points executive management can have been through in making decisions on whether or not to provide for an exposure on state aid.



- Economic and political update
- Digital – the nine big shifts
- The Social Enterprise
- Reporting on climate change
- Diversity and inclusion
- The 2020 Stewardship Code
- Managing risk
- Internal control and the board
- Non-executive pay
- The Section 172(1) Statement
- FRC reporting messages
- Reporting on the 2018 Code
- Taxation and state aid
- Simplifying corporate structures
- Audit market reform update
- Appendix



### Questions for non-executive directors to pose to management

- Do we consider that any of our UK tax payers in our group have an exposure with regard to state aid following the EC's decision? If so, is this material?
- How advanced is the analysis of whether significant people functions were provided in the UK and does management consider this to be conclusive evidence?
- Have we sought external advice, in particular from counsel, what is their conclusion and are there any next steps at this stage?
- Have we appealed the EC decision individually or do we expect to do so?
- How do the answers to these questions affect the decision making process we have gone through on whether and how much to provide?
- Have we compared our decision on whether and how much to provide to available disclosures from other industry participants and are they consistent?
- Are we satisfied with the nature and quality of our annual report disclosures?

### Contacts – Tax

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Economic and political update

Digital – the nine big shifts

The Social Enterprise

Reporting on climate change

Diversity and inclusion

The 2020 Stewardship Code

Managing risk

Internal control and the board

Non-executive pay

The Section 172(1) Statement

FRC reporting messages

Reporting on the 2018 Code

Taxation and state aid

Simplifying corporate structures

Audit market reform update

Appendix



# Simplifying corporate structures

Have you as a board ever questioned why you have so many companies in your group structure and what they are all for? Do they have a valuable purpose or do they just increase risk and give the impression of opaqueness? This article explains why simplification is desirable not just for stakeholder transparency but also for internal accountability within companies. As you look over your annual report this year, perhaps it would be worth asking why you have all those companies listed as subsidiaries?

## Why are stakeholders increasingly focused on corporate structures?

Market forces including globalisation, sophisticated capital structures and M&A activity have increased the complexity of corporate structures.

In parallel, the level of scrutiny over large groups has risen as a variety of stakeholders seek to enhance the transparency of corporations and hold boards to account for the governance of their corporate footprint.

Key drivers include:

- a. Regulatory pressure** – this is especially relevant in financial services sector where regulators require transparent reporting on group structures to assess risks and clearly identify where regulated business is conducted within a group.
- b. Government scrutiny** – the recent report published by MP's on the collapse of Carillion openly criticises the Board for presiding over an unnecessarily complex structure which made information flows difficult.
- c. Tax transparency** – tax has become a reputational issue for boards and several mandatory tax transparency regimes are being implemented across the world with tax authorities increasingly demanding more detailed disclosures.

- d. IFRS 12** – this accounting standard requires disclosures about subsidiaries in group financial statements, resulting in detailed information on the group structure becoming publicly available.
- e. Companies Act 2006 S409** – similarly this legislation sets out the requirements for information on related undertakings to be provided in the notes to annual accounts for UK companies.
- f. Shareholder activism** – with greater information at their disposal activist shareholders are increasingly challenging boards to explain, and even in some well publicised examples change the structure of a business.
- g. Transparency and risk** – having multiple entities in a group has sometimes been viewed as a method to isolate risk at affordable cost. Now, however, following recent failures, buyers, particularly Government are looking more closely at the contracting company and refusing to deal with overly complex structures, and want to work with larger more resilient entities

Economic and political update

Digital – the nine big shifts

The Social Enterprise

Reporting on climate change

Diversity and inclusion

The 2020 Stewardship Code

Managing risk

Internal control and the board

Non-executive pay

The Section 172(1) Statement

FRC reporting messages

Reporting on the 2018 Code

Taxation and state aid

Simplifying corporate structures

Audit market reform update

Appendix



### How can simplifying your corporate structures support effective governance?

From a governance perspective there are several challenges that unnecessarily complex group structures may create for a board:

- Line of sight governance accountability can become challenged in complex group structures.
- Unnecessarily complex structures may generate risks whilst delivering limited (if any) economic benefits. For example, contingent off-balance sheet liabilities can often lie in legacy entities where corporate memory may have faded.
- Directors of non-core subsidiaries are often senior executives with significant board level responsibilities. Dealing with a high volume of appointments, particularly in territories with unfamiliar local rules and regulations, can consume significant time, which is then not available to deal with the value added activities of the business.

One of the avenues open to boards to address these issues is to reduce complexity by eliminating legal entities which do not provide an economic benefit to the business. The benefits of which may include:

- A less complex structure will enhance transparency by aligning the corporate footprint more closely to the business' operating model.
- Accountability is improved because a more streamlined structure will enhance the visibility of risks faced by a business and enable these to be dealt with more efficiently.

- The process of liquidation is a proven tool in flushing out legacy contingent liabilities and concluding them.
- A greater proportion of senior management time and resource can be spent focused on the key value creating activities of a business.

#### Matters for boards to consider

- Do you have a clear understanding of the group structure, the number of entities within the group and how many continue to be active?
- Is there scope to reduce the level of complexity within the group structure by eliminating entities so that there a more transparent group structure with enhanced levels of accountability and which enable senior executives to focus their time on strategic priorities?

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Economic and political update

Digital – the nine big shifts

The Social Enterprise

Reporting on climate change

Diversity and inclusion

The 2020 Stewardship Code

Managing risk

Internal control and the board

Non-executive pay

The Section 172(1) Statement

FRC reporting messages

Reporting on the 2018 Code

Taxation and state aid

Simplifying corporate structures

Audit market reform update

Appendix



# The reform agenda – a status report

This article provides an update on the status and most likely next steps for the Government's company, regulator and audit reform agenda. After a busy first half of the year and consultation over the summer, we are in a 'holding pattern' now with BEIS considering next steps but promising further detail in Q1 2020.

## Independent Review of the Financial Reporting Council

This review, led by Sir John Kingman, focused on:

- The leadership, structure and funding arrangements of the FRC
- Audit regulation (including audit quality)
- Corporate reporting
- Enforcement – holding directors to account
- Stewardship
- Role of the regulator in avoiding corporate failure

## Activity to date

83 recommendations were made to the Government in December 2018, which can be split into three categories:

- Can be delivered immediately
- Do not require legislation but are policy choices
- Require legislation which will be consulted on later

It was announced that the FRC will be replaced by the Audit, Reporting & Governance Authority. A new Chair (Simon Dingemans) and CEO (Sir Jon Thompson) took up their positions in October (see boxes on next page).

BEIS undertook an initial consultation on some of the Kingman recommendations between March and June. The responses to that consultation are being considered by BEIS.

## Expected next steps

A further consultation on options is expected in Q1 2020, with a consultation on amendments to the Companies Act expected later in 2020 (although, disappointing to some, there was no specific reference to this in the recent Queen's Speech).

## Proposals of most significance to directors

### Being taken forward immediately:

- Regulator's Corporate Reporting Review will cover the whole annual report plus public reporting of findings and related correspondence
- A new market intelligence function set up to identify indicators of corporate failure

### To be the subject of future consultation:

- Regulation of a wider range of investor information
- Review of the definition of Public Interest Entity
- Greater accountability of relevant directors (i.e. Chair, CEO, CFO & AC Chair)
- An enhanced framework for internal controls (see article Internal control and the board: What is all the fuss about?)

Economic and political update

Digital – the nine big shifts

The Social Enterprise

Reporting on climate change

Diversity and inclusion

The 2020 Stewardship Code

Managing risk

Internal control and the board

Non-executive pay

The Section 172(1) Statement

FRC reporting messages

Reporting on the 2018 Code

Taxation and state aid

Simplifying corporate structures

Audit market reform update

Appendix





### The new Chair of the FRC – Simon Dingemans

*Simon was Chief Financial Officer and a member of the Main Board of GlaxoSmithKline plc from January 2011 - May 2019. Prior to joining GSK he was a Managing Director and Partner at Goldman Sachs. Simon served as Chairman of the 100 Group of Finance Directors between 2014 and 2016.*

### The new CEO of the FRC – Sir Jon Thompson

*Prior to joining the FRC Jon was the CEO of HMRC. Before HMRC, Jon was Permanent Secretary of the Ministry of Defence, jointly leading the organisation with the Chief of the Defence Staff. Jon has had a lengthy finance career including as Director General, Finance at the MoD, Director General, Corporate Services at the Department for Education and Finance Director of Ofsted.*

### Statutory audit services market study by the Competition & Markets Authority (CMA)

The CMA's market study focuses on:

- The scope and purpose of audit
- Audit firm incentives
- Choice & switching of auditors
- The resilience of the audit market
- Regulation of audit in the UK

### Activity to date

The CMA presented its final report to BEIS on 18 April. It put forward four recommendations:

- Increased scrutiny of audit committees
- Mandatory joint audit for all but the largest companies in the FTSE 350
- Operational split between the provision of audit and non-audit services in the Big Four
- Five-year review of progress

BEIS responded with a formal consultation on those recommendations in July 2019. The consultation closed in September and BEIS is considering the responses and continuing with further outreach to gather views.

### Expected next steps

A further consultation on these recommendations is expected in Q1 2020.

### Proposals of most significance to directors (particularly members of audit committees):

- Minimum standards for appointment and oversight of auditors
- Enhanced regulatory scrutiny on audit committee activities including increased reporting
- The possibility of observers from the regulator in audit committee meetings
- Possible mandatory joint audit for FTSE 350 with a requirement for one of the auditors to be a "Challenger Firm"

Economic and political update

Digital – the nine big shifts

The Social Enterprise

Reporting on climate change

Diversity and inclusion

The 2020 Stewardship Code

Managing risk

Internal control and the board

Non-executive pay

The Section 172(1) Statement

FRC reporting messages

Reporting on the 2018 Code

Taxation and state aid

Simplifying corporate structures

Audit market reform update

Appendix



## On the board agenda 2020

- Importance of the use of specialists should be high on the audit committee agenda – recognition that pricing will increase for specialists
- Impact on audit firm business model, resilience and investment capacity from an operational split, and long term attractiveness of the profession at senior levels

### Independent Review of the quality and effectiveness of audit

In December 2018, Sir Donald Brydon was asked by BEIS to conduct this review, focusing on:

- The needs and expectations of stakeholders in relation to audit
- Scope of audit
- Provision of assurance
- Liability of auditors
- Communication of audit findings
- International engagement and cohesion

He is being supported by three advisory groups in place: user-dominated, audit profession & technology.

### Activity to date

In addition to a huge amount of face-to-face outreach, a preliminary call for views was issued in April seeking views on 60 questions across a number of key themes, such as:

- Definitions of audit and its users
- The “expectation gap”
- Audit and wider assurance
- The scope and purpose of audit
- Audit product and quality
- Legal responsibilities of directors
- The communication of audit findings
- Role of audit in relation to fraud
- Auditor liability

### Expected next steps

Sir Donald Brydon provided the following update in early November 2019:



### The Future of Audit inquiry

This inquiry was set up by the BEIS Committee to focus on:

- The relationship between competition and quality in the audit market
- The proposals from the Kingman and CMA Reviews
- The impact of conflicts of interest (perceived or otherwise) on trust in audit
- The level of challenge in audit and the role of investors in ensuring audit quality
- Links to other corporate governance reforms

### Activity to date

The BEIS Committee issued its final report to BEIS in April. It issued its recommendations under five key areas:

- Capital maintenance
- Role of directors
- The audit product
- Audit regulation
- The audit profession

BEIS responded to the report by incorporating some of the BEIS Committee recommendations into its consultation on the CMA recommendations (see above).

Economic and political update

Digital – the nine big shifts

The Social Enterprise

Reporting on climate change

Diversity and inclusion

The 2020 Stewardship Code

Managing risk

Internal control and the board

Non-executive pay

The Section 172(1) Statement

FRC reporting messages

Reporting on the 2018 Code

Taxation and state aid

Simplifying corporate structures

Audit market reform update

Appendix



**The new Secretary of State for Business, Energy & Industrial Strategy – The Rt Hon Andrea Leadsom**

*In a recent appearance before the BEIS Committee, Andrea Leadsom set out the three “absolute” priorities for BEIS:*

1. *Delivering the path to net zero*
2. *Tackling our grand challenges, from life sciences to space*
3. *Making the UK the best place in the world to work or to grow a business*

*It is under the third priority that these reforms will be addressed and Andrea Leadsom has re-confirmed the Q1 2020 timetable for next steps on this agenda.*

**What should directors do this year end?**

- Ensure that the Audit Committee Report in the Annual Report is comprehensive and demonstrates effective challenge of management judgments
- Ensure that Audit Committee’s supervision of and quality assessment of external audit is clear
- Enhance the quality of Business Model, Risk Management and Viability statement disclosures
- Ensure that there has been a robust assessment of the effectiveness of internal controls and ensure that deficiencies noted are disclosed – see article ‘Internal control and the board: What is all the fuss about?’
- Ensure that the climate risk assessment has been done effectively and is properly disclosed and the company’s strategy as part of the path to net zero is thought through – see article ‘Reporting on climate change’

Economic and political update

Digital – the nine big shifts

The Social Enterprise

Reporting on climate change

Diversity and inclusion

The 2020 Stewardship Code

Managing risk

Internal control and the board

Non-executive pay

The Section 172(1) Statement

FRC reporting messages

Reporting on the 2018 Code

Taxation and state aid

Simplifying corporate structures

Audit market reform update

Appendix



# Appendix

Economic and political update

Digital – the nine big shifts

The Social Enterprise

Reporting on climate change

Diversity and inclusion

The 2020 Stewardship Code

Managing risk

Internal control and the board

Non-executive pay

The Section 172(1) Statement

FRC reporting messages

Reporting on the 2018 Code

Taxation and state aid

Simplifying corporate structures

Audit market reform update

Appendix



# Appendix: key questions for this reporting season

## The nine big shifts – Moving from ‘doing digital’ to ‘being digital’

- How mature is your organisation’s digital journey? Are you still in earlier phases: leveraging digital technologies to extend operational capabilities (often focused on customer channels only), while still relying on traditional business, operations and talent? Or have you reached higher levels of digital maturity where digital traits and a digital mindset define their corporate outlook and behaviour?
- Rather than simply ‘doing’ digital projects, has the organisation adopted an integrated strategy that makes you digital at your core?

## Leading the social enterprise – reinvent your company with purpose

- Is your corporate purpose and your culture well-aligned and linked in both to job roles and to the reward system? Does the corporate purpose inform individual personal growth objectives?
- Have you considered how the organisation will be transformed by technology and whether any adaptation of organisational structures needs to be considered?
- Does the board and do executive leaders within your organisation show themselves to be transparent, open and learning from mistakes?

## Reporting on climate change

- Ensure that climate change is regularly on the board agenda and that governance over climate change has been established.
- Ensure both the risks climate change poses to the business and the risk that the business poses to the climate have been considered when establishing principal risks and drafting the strategic report.
- Consider how to disclose climate change in the strategic report, taking into account the FRC’s expectations and assessing how far the business can go towards meeting the TCFD recommendations.
- For the audit committee, query what assumptions, judgements and estimates relating to climate risk have been incorporated into the preparation of the financial statements. For example, where you have performed scenario analysis, has this been reflected in cash flow forecasts supporting impairment reviews and other asset valuations?

## Diversity and inclusion

- Have you considered whether the board’s policy on diversity at board level and the policy on diversity and inclusion throughout the organisation is in step with the new demands of the 2018 UK Corporate Governance Code? Are the policies clearly reported in the annual report, together with objectives and outcomes?
- Does your board treat diversity both at board level and throughout the organisation as an opportunity and a matter of strategic importance? Is it given sufficient time at board level?
- Do you have a clear view on the diversity challenges throughout your organisation, the actions being taken to increase diversity where necessary, and this year’s gender pay gap results?
- Do you have an understanding of your ethnicity pay gap and have you considered whether to report on the ethnicity pay gap publicly, before legislation demands it?

## A new benchmark for stewardship – the 2020 Stewardship Code

- What steps is the board taking to understand the views of major shareholders and to seek engagement with shareholders on significant matters related to their areas of responsibility?
- How much awareness does the board have of the share register and whether the company’s major shareholders are signatories to the Stewardship Code?

## Managing risk

- Do you have a robust set of procedures covering emerging risks that incorporate effective horizon-scanning and triggers to elevate promptly to the board any risks that emerge and crystallise rapidly?
- Are the privacy and cyber programmes mature and the subject of regular updates to the board? Has the board considered where ownership would sit in the case of a significant breach and who would be responsible for ensuring “business as usual”?

Economic and political update

Digital – the nine big shifts

The Social Enterprise

Reporting on climate change

Diversity and inclusion

The 2020 Stewardship Code

Managing risk

Internal control and the board

Non-executive pay

The Section 172(1) Statement

FRC reporting messages

Reporting on the 2018 Code

Taxation and state aid

Simplifying corporate structures

Audit market reform update

Appendix



#### Internal control and the board: What is all the fuss about?

- Are the risk management and internal control systems appropriate for the company's business model?
- How are authority, responsibility and accountability for risk management and internal control defined, co-ordinated and documented throughout the organisation?
- Has a financial risk assessment been undertaken? What does it tell us?
- Have "material controls" been defined for the business? Where are material risks apparent and decisions taken?
- Can management provide an analysis of material controls by process and central function and provide details around how they are assured?
- Is the company clear about which IT systems are material to financial reporting, operating or compliance controls and have the IT controls been tested?
- At an entity level, has the board considered how the company's culture, code of conduct, human resource policies and performance reward systems support the business objectives and risk management and internal control systems?
- Has management undertaken a fraud risk analysis, including the risk of fraud in financial reporting?
- What are the channels of communication that enable individuals, including third parties, to report concerns, suspected breaches of law or regulations, other improprieties or challenging perspectives?
- How does the board satisfy itself that the information it receives is timely, of good quality, reflects numerous information sources and is fit for purpose?
- Are the papers supporting the board's annual review of effectiveness of internal controls sufficiently comprehensive to support the conclusions, or are the papers more of an "exception report"?
- If the annual review of effectiveness has revealed areas where more needs to be done to enhance material operational, financial or compliance controls, are these areas appropriately disclosed in the annual report?

#### Non-executive pay

- Expectations and profile of the NED role are shifting, with increasing time commitments linked to governance changes, in particular for audit and remuneration committee chairs.

- With growing pressure around 'overboarding', boards should ensure time commitment is recognised and fairly rewarded, to ensure UK listed companies are able to attract the calibre and diversity of talent needed to oversee companies.

#### The Section 172(1) statement – getting it right

- Is the statement included in the Strategic Report?
- Is the statement separately identifiable?
- Does it explain the issues, factors and stakeholders which you, the directors, have considered relevant in complying with your section 172 duty? Does the statement explain how the board came to that view on relevance?
- How consistent is the list of relevant issues, factors and stakeholders to the existing disclosures of key dependencies (resources and relationships) in the business model section of the annual report?
- For each relevant stakeholder, is the statement cross-referencing to appropriate and meaningful existing annual report disclosures which describe the engagement mechanisms used to understand the issues to which the directors should have regard?
- Is it made clear in the statement how the board uses the output of that engagement in the board decision-making process?
- Does the statement include specific examples which demonstrate the effect of that regard on the company's decisions and strategies during the financial year?
- How well do the examples provided align to key events which took place during the year? The CEO and CFO statements are likely to be good reference points for key events.
- Is the statement reflective of and consistent with the size and complexity of the business?
- Overall, are you, as a director, comfortable that the statement accurately captures the considerations taken into account by the board when making decisions during the year?

Economic and political update

Digital – the nine big shifts

The Social Enterprise

Reporting on climate change

Diversity and inclusion

The 2020 Stewardship Code

Managing risk

Internal control and the board

Non-executive pay

The Section 172(1) Statement

FRC reporting messages

Reporting on the 2018 Code

Taxation and state aid

Simplifying corporate structures

Audit market reform update

Appendix



#### Key messages for 2019/2020 reporting season annual reports

- Is the board confident in the quality and content of the strategic report and how the new requirements of the section 172(1) statement have been met? Does the strategic report make it easy for a reader to understand the sources and uses of cash?
- Does the annual report clearly describe the judgements and estimates and provide enough information for the reader to have a good understanding of how each of these may change over the coming year?
- Has enough information been brought to the board / audit committee and reflected in the annual report regarding the implementation of new accounting standards, in particular IFRS 16?

#### The new UK Corporate Governance Code – focusing on activities and outcomes

- Is it clear that the corporate governance section of the annual report is addressing the 2018 UK Corporate Governance Code?
- Does the corporate governance section clearly explain how the principles of the Code have been applied in addition to confirming the level of compliance with the Code provisions?
- Is there discussion of activities and outcomes in the year in addition to description of policies and processes?
- Is the board confident that key governance documents, e.g. terms of reference, delegated authorities etc, have been updated to reflect the new Code and the disclosures provided in the annual report?

#### Taxation – state aid

- Do we consider that any of our UK tax payers in our group have an exposure with regard to state aid following the EC's decision? If so, is this material?
- How advanced is the analysis of whether significant people functions were provided in the UK and does management consider this to be conclusive evidence?
- Have we sought external advice, in particular from counsel, what is their conclusion and are there any next steps at this stage?
- Have we appealed the EC decision individually or do we expect to do so?

- How do the answers to these questions affect the decision making process we have gone through on whether and how much to provide?
- Have we compared our decision on whether and how much to provide to available disclosures from other industry participants and are they consistent?
- Are we satisfied with the nature and quality of our annual report disclosures?

#### Simplifying corporate structures

- Do you have a clear understanding of the group structure, the number of entities within the group and how many continue to be active?
- Is there scope to reduce the level of complexity within the group structure by eliminating entities so that there is a more transparent group structure with enhanced levels of accountability and which enables senior executives to focus their time on strategic priorities?

#### The reform agenda – a status report

- Ensure that the Audit Committee Report in the Annual Report is comprehensive and demonstrates effective challenge of management judgments.
- Ensure that Audit Committee's supervision of and quality assessment of external audit is clear.
- Enhance the quality of Business Model, Risk Management and Viability statement disclosures.
- Ensure that there has been a robust assessment of the effectiveness of internal controls and ensure that deficiencies noted are disclosed.
- Ensure that the climate risk assessment has been done effectively and is properly disclosed and the company's strategy as part of the path to net zero is thought through.

Economic and political update

Digital – the nine big shifts

The Social Enterprise

Reporting on climate change

Diversity and inclusion

The 2020 Stewardship Code

Managing risk

Internal control and the board

Non-executive pay

The Section 172(1) Statement

FRC reporting messages

Reporting on the 2018 Code

Taxation and state aid

Simplifying corporate structures

Audit market reform update

Appendix



# Further resources

Throughout this publication we have mentioned some of our other publications where they offer a deeper dive on the governance topics of interest, or where we believe they can add insight to your role as a board member.

This section pulls together those additional resources with a brief introduction to each of them, so they are easier to refer to when required. We also provide a helpful table where you can identify and click through to the publications by Deloitte and others that are referenced in this publication.

As always, do get in touch with your Deloitte partner or with us in the Deloitte governance team if you would like to discuss any areas in more detail. All our recent governance publications are available to read and download from [www.deloitte.co.uk/governancelibrary](http://www.deloitte.co.uk/governancelibrary).

## Governance in Brief

***FRC issues advice on annual reports for 2019/20 reporting season*** considers the FRC's Annual Review of Corporate Reporting, the recommendations in the FRC's year-end advice letter to preparers and the aspects of financial statements and broader corporate reporting that the FRC is looking to companies to focus on in the coming year.



***Auditor independence rules*** explores the Financial Reporting Council's consultation on proposed changes to auditor independence rules and limited proposed changes to UK auditing standards.



Economic and political update

Digital – the nine big shifts

The Social Enterprise

Reporting on climate change

Diversity and inclusion

The 2020 Stewardship Code

Managing risk

Internal control and the board

Non-executive pay

The Section 172(1) Statement

FRC reporting messages

Reporting on the 2018 Code

Taxation and state aid

Simplifying corporate structures

Audit market reform update

Appendix





**Government consults on the CMA's proposals for statutory audit services**

represents the latest in the Government's programme to strengthen and improve quality and regulatory oversight of the audit market.



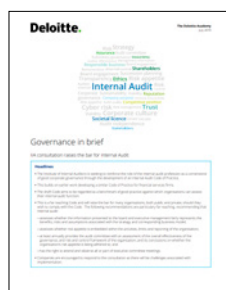
**Other Deloitte publications**

**Board briefing on the new Section 172(1) statement** sets out a deeper dive into the messages and questions which companies may wish to consider when assessing the impact of engagement activities under the new required statement.



**IIA consultation raises the bar on internal audit**

explains the development of an Internal Audit Code of Practice by The Institute of Internal Auditors. The draft Code aims to be regarded as a benchmark of good practice against which organisations can assess their internal audit function.

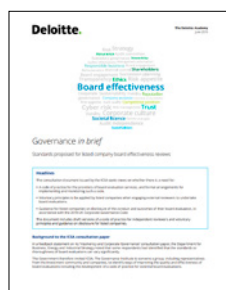


**Annual report insights 2019** gives a comprehensive picture of narrative and financial reporting trends for UK listed companies, together with ideas and examples to help them improve their annual reports.



**Standards proposed for listed company board effectiveness reviews**

is a guide for listed companies on disclosure of the conduct and outcomes of their board evaluation, in accordance with the 2018 UK Corporate Governance Code. The document includes draft versions of a code of practice for independent reviewers and voluntary principles and guidance on disclosure for listed companies.



**Closing out 2019** is a one-stop guide which covers the principal narrative and financial reporting issues that are relevant to annual reports for the 2019 reporting season.



Economic and political update

Digital – the nine big shifts

The Social Enterprise

Reporting on climate change

Diversity and inclusion

The 2020 Stewardship Code

Managing risk

Internal control and the board

Non-executive pay

The Section 172(1) Statement

FRC reporting messages

Reporting on the 2018 Code

Taxation and state aid

Simplifying corporate structures

Audit market reform update

Appendix



**Global Human Capital Trends 2019** examines some key human capital trends in 2019 and how companies are responding by redesigning organisational behaviour. This publication explores the rise of the social enterprise and why social capital has become just as important as human, financial and physical capital. In the social enterprise, good citizenship is a CEO-level strategy.



**UK Human Capital Trends 2019** summarises the difference between the main global and UK human capital trends and highlights areas for UK leaders to consider.



**Hearing the stakeholder voice** is a guide intended to help companies identify the key actions required to implement and report on effective engagement mechanisms, which will be a requirement of the UK Corporate Governance Code from 2019, as well as exploring the challenges boards may face along the way.



**Thinking allowed: climate related disclosure** explores how corporate reporting is evolving to meet the expectations of investors with regard to climate change. In this publication we look at some of the issues involved and how companies and audit committees might respond to the challenges, drawing on a report issued by the FSB Task Force on Climate-related Financial Disclosure, to integrate the implications of climate change in their corporate reporting effectively.



**Your guide: Directors' remuneration in FTSE 100 companies** presents analysis and insights regarding executive directors' remuneration in the FTSE 100, based on the 2019 AGM season.



**Your guide: Directors' remuneration in FTSE 250 companies** presents analysis and insights regarding executive directors' remuneration in the FTSE 250, based on the 2019 AGM season.



Economic and political update

Digital – the nine big shifts

The Social Enterprise

Reporting on climate change

Diversity and inclusion

The 2020 Stewardship Code

Managing risk

Internal control and the board

Non-executive pay

The Section 172(1) Statement

FRC reporting messages

Reporting on the 2018 Code

Taxation and state aid

Simplifying corporate structures

Audit market reform update

Appendix



**Publications referred to throughout On the board agenda 2020**

The UK Corporate Governance Code 2018 can be found on the FRC's website at the following link: [The UK Corporate Governance Code 2018](#).

Other publications referred to throughout On the board agenda can be found at the links below:

Article	Page	Publication	Hyperlink
The nine big shifts – Moving from 'doing digital' to 'being digital'	9	Nine big shifts that will determine your future Business of Technology (Deloitte)	<a href="#">Nine big shifts that will determine your future Business of Technology</a>
Leading the social enterprise – reinvent your company with purpose	12	2019 Global Human Capital Trends	<a href="#">2019 global Human Capital Trends</a>
		2019 UK Human Capital Trends (Deloitte)	
<b>Responsible business</b>			
Reporting on climate change	16	Government's Green finance strategy	<a href="#">Green finance strategy</a>
	16	FRC statement on the Government's Green Finance Strategy	<a href="#">FRC statement on the Government's Green Finance Strategy</a>
	16	The FRC's Financial Reporting Lab – Climate-related corporate reporting	<a href="#">Climate-related corporate reporting</a>
	16	Task Force on Climate-related Financial Disclosures (TCFD)	<a href="#">Task Force on Climate-related Financial Disclosures (TCFD)</a>
	21	EU Taxonomy	<a href="#">EU Taxonomy</a>
	21	EU Green Bond Standard	<a href="#">EU Green Bond Standard</a>
	21	EU Report on benchmarks	<a href="#">Report on benchmarks</a>
	21	EU Guidelines on reporting climate-related information	<a href="#">Guidelines on reporting climate-related information</a>

- Economic and political update
- Digital – the nine big shifts
- The Social Enterprise
- Reporting on climate change
- Diversity and inclusion
- The 2020 Stewardship Code
- Managing risk
- Internal control and the board
- Non-executive pay
- The Section 172(1) Statement
- FRC reporting messages
- Reporting on the 2018 Code
- Taxation and state aid
- Simplifying corporate structures
- Audit market reform update
- Appendix



Diversity and inclusion	22	Annual report insights 2019 (Deloitte)	<a href="#">Annual report insights 2019</a>
	24	ISS proposed benchmark policy changes for 2020	<a href="#">Proposed benchmark policy changes for 2020</a>
	24	FRC Guidance on Board Effectiveness	<a href="#">Guidance on Board Effectiveness</a>
	22	The Hampton-Alexander Review 2019	<a href="#">The Hampton-Alexander Review 2019</a>
	25	Women in the boardroom: A Global perspective (Deloitte)	<a href="#">Women in the boardroom</a>
	25	Gender pay gap reporting: no excuses (EHRC)	<a href="#">Gender pay gap reporting: no excuses</a>
	26	Understanding pay gaps (Bank of England)	<a href="#">Understanding pay gaps</a>
A new benchmark for stewardship – the 2020 Stewardship Code	27	The UK Stewardship code 2020	<a href="#">The UK Stewardship code 2020</a>
<b>Risk &amp; internal controls</b>			
Managing risk	31	OnRisk 2020: A Guide to Understanding, Aligning, and Optimizing Risk	<a href="#">OnRisk 2020: A Guide to Understanding, Aligning, and Optimizing Risk</a>
	32	FRC Guidance on Audit Committees	<a href="#">Guidance on Audit Committees</a>
	32	FRC Guidance on Risk Management, Internal Control and Related Financial and Business Reporting	<a href="#">Guidance on Risk Management, Internal Control and Related Financial and Business Reporting</a>
	32	Annual report insights 2019 (Deloitte)	<a href="#">Annual report insights 2019</a>
Internal control and the board: What is all the fuss about?	36	Sir John Kingman's Independent Review of the Financial Reporting Council	<a href="#">Sir John Kingman's Independent Review of the Financial Reporting Council</a>
	35	FRC Guidance on Risk Management, Internal Control and Related Financial and Business Reporting	<a href="#">Guidance on Risk Management, Internal Control and Related Financial and Business Reporting</a>

Economic and political update

Digital – the nine big shifts

The Social Enterprise

Reporting on climate change

Diversity and inclusion

The 2020 Stewardship Code

Managing risk

Internal control and the board

Non-executive pay

The Section 172(1) Statement

FRC reporting messages

Reporting on the 2018 Code

Taxation and state aid

Simplifying corporate structures

Audit market reform update

Appendix



<b>Year-end reporting &amp; assurance update</b>			
The Section 172(1) statement – getting it right	48	FRC Annual letter to finance directors and Audit Committee chairs	<a href="#">Annual letter to CFO and AC</a>
	48	The Companies (Miscellaneous Reporting) Regulations 2018	<a href="#">Miscellaneous Reporting</a>
	48	Board briefing on the new section 172(1) Statement	<a href="#">Board briefing on the new section 172(1) Statement</a>
Key messages for 2019/2020 reporting season annual reports	50	FRC Annual review of corporate reporting 2018/2019	<a href="#">Annual review of corporate reporting 2018/2019</a>
	50	FRC Annual letter to finance directors and Audit Committee chairs	<a href="#">Annual letter to CFO and AC</a>
	50	Green Finance strategy	<a href="#">Green Finance strategy</a>
	50	Task Force on Climate-related Financial Disclosures (TCFD)	<a href="#">Task Force on Climate-related Financial Disclosures (TCFD)</a>
	52	ESMA guidelines on Alternative performance measures	<a href="#">ESMA guidelines on Alternative performance measures</a>
	55	FRC Lab report Disclosures on the sources and uses of cash	<a href="#">Disclosures on the sources and uses of cash</a>
The reform agenda – a status report	64	Sir John Kingman's Independent Review of the Financial Reporting Council	<a href="#">Sir John Kingman's Independent Review of the Financial Reporting Council</a>
	65	CMA Statutory audit services market study	<a href="#">Statutory audit services market study</a>
	66	BEIS Select Committee report on The Future of Audit	<a href="#">The Future of Audit</a>

Economic and political update

Digital – the nine big shifts

The Social Enterprise

Reporting on climate change

Diversity and inclusion

The 2020 Stewardship Code

Managing risk

Internal control and the board

Non-executive pay

The Section 172(1) Statement

FRC reporting messages

Reporting on the 2018 Code

Taxation and state aid

Simplifying corporate structures

Audit market reform update

Appendix



# The Deloitte Centre for Corporate Governance

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Economic and political update

Digital – the nine big shifts

The Social Enterprise

Reporting on climate change

Diversity and inclusion

The 2020 Stewardship Code

Managing risk

Internal control and the board

Non-executive pay

The Section 172(1) Statement

FRC reporting messages

Reporting on the 2018 Code

Taxation and state aid

Simplifying corporate structures

Audit market reform update

Appendix



# The Deloitte Academy

The Deloitte Academy provides support and guidance to boards, committees and individual directors, principally of the FTSE 350, through a series of briefings and bespoke training. The Deloitte Academy is available to board directors of listed companies, and includes access to the Deloitte Academy business centre between Covent Garden and the City.

Members receive copies of our regular publications on Corporate Governance and a newsletter. There is also a dedicated members' website [www.deloitteacademy.co.uk](http://www.deloitteacademy.co.uk) which members can use to register for briefings and access additional relevant resources.

For further details about the Deloitte Academy, including membership, please email [enquiries@deloitteacademy.co.uk](mailto:enquiries@deloitteacademy.co.uk).



Economic and political update

Digital – the nine big shifts

The Social Enterprise

Reporting on climate change

Diversity and inclusion

The 2020 Stewardship Code

Managing risk

Internal control and the board

Non-executive pay

The Section 172(1) Statement

FRC reporting messages

Reporting on the 2018 Code

Taxation and state aid

Simplifying corporate structures

Audit market reform update

Appendix





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