ICAEW REPRESENTATION
92/14

APRIL 2014 PROPOSED REVISIONS TO THE UK CORPORATE GOVERNANCE CODE

ICAEW welcomes the opportunity to comment on the consultation document *Proposed Revisions to the UK Corporate Governance Code* published by the Financial Reporting Council on 24 April 2014, a copy of which is available from this link.

In preparing our response, we have sought input from individuals drawn from the full breadth of our membership, including listed company directors and audit committee members, audit practitioners and consultants in public practice. ICAEW expects to apply any new guidance on risk management and internal control to its own business and in its own public reporting. This ICAEW response of 1 July 2014 reflects consultation with ICAEW's office holders, Technical Strategy Board and Corporate Governance Committee.

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ICAEW members operate across a wide range of areas in business, practice and the public sector. They provide financial expertise and guidance based on the highest professional, technical and ethical standards. They are trained to provide clarity and apply rigour, and so help create long-term sustainable economic value.

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MAJOR POINTS

1. We welcome the opportunity to respond to the Financial Reporting Council's consultation document *Proposed Revisions to the UK Corporate Governance Code.* We are largely supportive of the FRC's proposals to amend the Code in respect of remuneration and publishing corporate governance information on company websites.

2. In respect of risk management and internal control, the FRC's approach has been to propose changes to the UK Corporate Governance Code and to substantially rewrite and integrate its existing, separate guidance on internal control and going concern. We support the FRC's intention to improve corporate risk management by implementing the findings of the Sharman Panel through the 2014 UK Corporate Governance Code update. We agree that the UK Corporate Governance Code should be the appropriate mechanism to raise expectations regarding board behaviour.

3. In general, we support the use of guidance to assist in the application of the UK Corporate Governance Code. However, given the short timeframe before the revised Code will become effective, we think the existing guidance should be left in place for now, rather than trying to rewrite the guidance before 1 October 2014. Leaving the existing guidance intact will allow the FRC time to reflect on implementation of revisions to the Code and to draw upon best practice in developing guidance for all companies. In a similar vein, we recommend strongly that revisions to auditing standards and specific guidance for directors of banks are developed and consulted upon alongside this new guidance rather than being issued now. This would be consistent with the FRC's approach to 'fair, balanced and understandable', whereby clear changes to the Code in 2012 were followed by guidance on the strategic report in 2014 based on best practice.

4. Leaving the existing guidance intact for now will also reduce uncertainty for non-Code companies. They currently rely upon the 2009 Guidance for Directors on going concern but it is unclear what guidance they will be expected to follow from 1 October 2014 were the proposed merged guidance on internal control and going concern to be issued. There is anxiety among non-Code companies, primarily SMEs, that the simplicity of the 2009 guidance may be lost or that elements of the combined guidance that are appropriate only for listed companies may be carried over into other companies.

5. We believe that it is important for the FRC to communicate its proposed revisions to the Code, particularly in relation to risk management and internal control, as reinforcing the UK's principles-based approach to corporate governance. In our recent publication 'What are the overarching principles of corporate governance?' we emphasised five principles and amongst these we believe that Accountability and Sustainability are most relevant to the 2014 proposed revisions.

The going concern statement

6. We agree with the proposal to change the existing statement that 'the business is a going concern' to make it clear that this refers to the going concern basis of accounting. However, we recommend that the FRC reconsider the wording of its proposed change to the Code Provision. We make a suggestion in this regard in the appendix to this response.

The long-term viability statement

7. We agree that there is a need to set high expectations for boards to encourage them to have regard to the viability of the company beyond the period considered for adopting the going concern basis of accounting. However, we propose that this is implemented by introducing clear expectations in the Code itself to encourage companies to approach this Code Provision under the existing 'fair, balanced and understandable' framework. Accordingly, we think this Code Provision should be included in the 'Financial and business reporting' section, with a clear cross-reference to the 'Risk management and internal control' section.

Rewriting the Turnbull and going concern guidance

8. We support the Sharman Panel recommendation to link the company's risk management and internal control processes to its assessment of the going concern basis of accounting and longer-term viability of the company. However, we have reservations about trying to reflect this approach now within new guidance to replace the existing Turnbull and going concern guidance. Preparing new guidance by 1 October 2014 presents serious challenges in terms of implementation and ensuring due process and we believe it would be better to delay issuing the guidance to allow for a fuller consideration and consultation.

Reporting on actions being taken to address weaknesses

9. We urge the FRC to reconsider its proposals on reporting on actions being taken to address significant failings or weaknesses. We are concerned that the consequences of introducing guidance which will be seen as requiring all companies to report on actions being taken to address weaknesses have not been fully considered, and that it would be preferable to learn from existing best practice first.

10. We understand that the FRC proposes to improve disclosure of actions being taken to address weaknesses not by making a change to the UK Corporate Governance Code but by changing guidance. We have reservations about whether such a change within guidance will be effective, and suggest that it would be better either to change the Code or to signal clear expectations of what kind of disclosure the FRC wants to see, to encourage better practice. A decision on whether further guidance or changes to the Code in the 2016 update are considered necessary could then be taken in the light of actual disclosures.

RESPONSES TO SPECIFIC QUESTIONS

SECTION 2: DIRECTORS' REMUNERATION

Question 1: Do you agree with the proposed changes in Section D of the Code?

11. We agree with the proposed changes in Section D to update Code Principle D.1 on executive directors' remuneration and performance-related elements and the Supporting Principle in relation to Code Principle D.2 on remuneration committees.

Question 2: Do you agree with the proposed changes relating to clawback arrangements?

12. We agree with the FRC to delete the statement that may be seen as limiting the circumstances where clawback may be used.

13. While we prefer the revised wording on clawback provisions, we think it should be retained within Schedule A rather than updating Code Provision D.1.1.

Question 3: Do you agree with the proposed change relating to AGM results? Is the intention of the proposed wording sufficiently clear?

14. We agree that the requirement to report on AGM results where there has been a significant minority vote against should be extended to apply to all resolutions. We also support the FRC's decision not to provide definitions of terms such as 'significant proportion' or 'substantial majority'.

Question 4: Do you agree with the proposed amendments to the Schedule?

15. Broadly, we support the idea of using remuneration to incentivise longer term thinking. However, while we agree with most of the proposed amendments to Schedule A, we can foresee some practical challenges with too much prescription in this area, for example in relation to directors continuing to hold shares after they have finished serving the company. The Schedule should take a non-prescriptive approach.

SECTION 3: RISK MANAGEMENT AND GOING CONCERN

Question 5: Do you agree with the changes to the Code relating to principal risks and monitoring the risk management system?

16. Given that the Strategic Review refers to principal risks, we agree with the amendment to the Code to refer to principal risks rather than significant risks.

17. We support the proposal for board oversight of risk management to be undertaken on an ongoing rather than an annual basis and in the appendix to this response have sought to simplify the wording to effect this change.

Question 6: Do you agree that companies should make two separate statements? If so, does the proposed wording make the distinction between the two statements sufficiently clear?

18. We agree with the FRC that board directors should make two separate statements, to distinguish the disclosure around the going concern basis of accounting from disclosures of the board's views on the longer term viability of the business. However, we think proposed Code Provision C.2.2 could be simplified as set out in the appendix to this response.

19. We also think that the statements should be required by C.1, which deals with reporting, rather than C.2. This would have the advantage that the disclosures around longer term viability would be subject to the 'fair, balanced and understandable' principle within C.1 and it would be clearer that the directors' judgements on going concern and viability are to be considered part of the same process rather than being isolated activities.

20. It is unclear to us to what 'the company's ability to continue to do so' in the proposed changes to Code Provision C.1.3 is intended to refer. Currently, under the 2012 UK Corporate Governance Code, the decision at any point in time whether to adopt the going concern basis of accounting requires consideration of a period of at least twelve months from the date of approval of the financial statements. The proposed revisions to C.1.3 would effectively require consideration of a period of at least 24 months, by requiring directors to disclose now any material uncertainties to the company's ability to adopt the going concern basis of accounting in twelve months' time, which in turn requires consideration of a further twelve month period under IAS 1. We don't believe this is the FRC's intention and we recommend that the FRC reconsider its proposed changes to Code Provision C.1.3. Our proposed wording of C.1.3 is set out in an appendix.

Question 7: Do you agree with the way proposed Provision C.2.2 addresses the issues of the basis of the assessment, the time period it covers and the degree of certainty attached?

21. Our response to this question should be considered alongside our response to Question 6, above.

22. We support the FRC's approach to the time period, which should encourage directors to think about and justify an appropriate period in the context of their company and its business model. However, we do not agree with the proposed wording in C.2.2 and, in an appendix, propose an alternative as a new C.1.4, in which we have sought to capture the intentions of Recommendation 4 of the Sharman Report. We are concerned that the proposed C.2.2 is too detailed. We think the FRC can set expectations of behaviour by board directors without a lengthy requirement within a Code provision.

23. Given the FRC's intention is for the Code to be effective for reporting periods beginning on or after 1 October 2014, we have concluded with regret that it is not possible at this stage to prepare authoritative guidance prior to the revised Code being issued. Therefore it is necessary for the wording of new Code provisions to be as clear and concise as possible so that the revised Code can be followed by board directors.

Question 8: Do you have any comments on the draft guidance in Appendix B on the going concern basis of accounting and / or the viability statement?

24. We found it difficult to review the draft guidance extracts without the context that would be provided by the rest of the guidance. We are concerned about the process for rewriting combined internal control and going concern guidance by 1 October 2014 without a further chance to comment on it. The existing internal control and going concern guidance documents are well understood and are, generally speaking, embedded within company processes. Therefore, it will require considerable effort to understand and implement the rewritten guidance in the absence of any clear trail between the existing guidance and the new guidance, for example in the form of a markup.

25. Given the very short timeframe before the revised UK Corporate Governance Code will become effective, we recommend that the FRC clearly set out its expectations within the Code provisions and allow more time for new guidance to be developed. We have attached as an appendix a markup showing how the Code provisions might be updated to achieve this.

Question 9: Should the FRC provide further guidance on the location of the viability statement?

26. We do not think further guidance is needed because we have no particular views on the location of the statement.

Question 10: Should the recommendation that companies report on actions being taken to address significant failings or weaknesses be retained? If so, would further guidance be helpful?

27. We urge the FRC to reconsider its proposals on reporting on actions being taken to address significant failings or weaknesses. We are concerned that the consequences of introducing guidance which will be seen as requiring all companies to report on actions being taken to address weaknesses have not been fully considered, and that it would be preferable to learn from existing best practice first. We are particularly concerned that an apparent requirement relating to significant failings or weaknesses will not gain traction in the absence of criteria for identifying such failings or weaknesses. Also, as noted in our response to Question 8 above, we are concerned that this consultation does not allow for review of the full supporting guidance.

28. We understand that the FRC proposes to improve disclosure of actions being taken to address weaknesses not by making a change to the UK Corporate Governance Code but by changing guidance. We have reservations about whether such a change within guidance will be effective, and suggest that it would be better either to change the Code or to signal clear expectations of what kind of disclosure the FRC wants to see, perhaps with reference to the 'fair, balanced and understandable' framework. A decision on whether further guidance or changes to the Code in the 2016 update are considered necessary could then be taken in the light of actual disclosures and best practice.

SECTION 5: LOCATION OF CORPORATE GOVERNANCE DISCLOSURES

Question 11: Should the option of giving companies the possibility of putting the full corporate governance statement on their website be considered further? If so, are there any elements of the corporate governance statement that should always be included in the annual report?

29. Generally, we support the idea of allowing companies to be innovative in how they communicate to investors and stakeholders, including through the use of their website. We have no particular views on whether any parts should be required to be included in the annual report. We suggest that companies are allowed to exercise judgement, taking into account the existing Disclosure and Transparency Rules within EU law, with the FRC reviewing effectiveness of disclosures in the light of this policy.

30. However, the FRC should challenge whether information that need not be disclosed in the annual report should be required to be disclosed at all. We doubt whether an approach that relegates particular disclosures to the company's website would answer this challenge. Instead, the FRC might identify factors a company should consider in determining whether particular disclosures need to be included in the annual report. For example, disclosures which are subject to audit might always need to be included in the annual report. Identifying factors for consideration would reinforce the FRC's existing messaging on 'cutting clutter' from annual reports.

Question 12: Are there any disclosure requirements in the Code that could be dropped entirely?

31. We do not have any immediate proposals for disclosure requirements that could be dropped entirely. However, we would support more detailed work in this area in advance of the 2016 revision of the Code.

Appendix: markup to the 2012 UK Corporate Governance Code to reflect comments in ICAEW Representation 92/14

Section C: Accountability

C.1: Financial And Business Reporting

Main Principle

The board should present a fair, balanced and understandable assessment of the company's position and prospects.

Supporting Principle

The board's responsibility to present a fair, balanced and understandable assessment extends to interim and other price-sensitive public reports and reports to regulators as well as to information required to be presented by statutory requirements.

The board should establish arrangements that will enable it to ensure that the information presented is fair, balanced and understandable.

Code Provisions

C.1.1. The directors should explain in the annual report their responsibility for preparing the annual report and accounts, and state that they consider the annual report and accounts, taken as a whole, is fair, balanced and understandable and provides the information necessary for shareholders to assess the company's position and performance, business model and strategy. There should be a statement by the auditor about their reporting responsibilities[10].

C.1.2. The directors should include in the annual report an explanation of the basis on which the company generates or preserves value over the longer term (the business model~~) and~~), the strategy for delivering the objectives of the company[11], and a description of the principal risks facing the company and how those risks are being managed or mitigated.

C.1.3. The directors should report in annual and ~~half-yearly~~interim financial statements that the business ~~is a~~ has adopted the going concern basis of accounting, with supporting assumptions or qualifications as necessary[12].

C.1.4 The directors should assess the viability of the company over a longer period than that considered for adopting the going concern basis of accounting in C.1.3 and should report on the results of that assessment.

C.2: Risk Management and Internal Control[13]

Main Principle

The board is responsible for determining the nature and extent of the ~~significant~~principal risks it is willing to take in achieving its strategic objectives. The board should maintain sound risk management and internal control systems.

Code Provision

C.2.1. The board should~~, at least annually, conduct a review of the effectiveness of~~ monitor the company's risk management and internal control systems and ~~should~~, at least annually, carry out a review of their effectiveness and report to shareholders that they have done so[14]. ~~The review~~This process should cover all principal risks, including solvency, liquidity and business viability risks, and all material controls, including financial, operational and compliance controls and should support the statements made under C.1.2, C.1.3 and C.1.4.

Section D: Remuneration

D.1: The Level and Components of Remuneration

Main Principle

~~Levels of remuneration should be sufficient to attract, retain and motivate directors of the quality required to run the company successfully, but a company should avoid paying more than is necessary for this purpose. A significant proportion of executive~~Executive directors' remuneration should be ~~structured so as to link rewards to corporate and individual performance.~~

~~Supporting Principle~~

~~The performance-related elements of executive directors' remuneration should be stretching and~~ **designed to promote the long-term success of the company. Performance-related elements should be stretching and rigorously applied.**

Supporting Principle

The remuneration committee should judge where to position their company relative to other companies. But they should use such comparisons with caution, in view of the risk of an upward ratchet of remuneration levels with no corresponding improvement in ~~performance~~corporate and individual performance, and should avoid paying more than is necessary.

They should also be sensitive to pay and employment conditions elsewhere in the group, especially when determining annual salary increases.

Code Provisions

D.1.1. In designing schemes of performance-related remuneration for executive directors, the remuneration committee should follow the provisions in Schedule A to this Code.

D.1.2. Where a company releases an executive director to serve as a non-executive director elsewhere, the remuneration report[21] should include a statement as to whether or not the director will retain such earnings and, if so, what the remuneration is.

D.1.3. Levels of remuneration for non-executive directors should reflect the time commitment and responsibilities of the role. Remuneration for non-executive directors should not include share options or other performance-related elements. If, exceptionally, options are granted, shareholder approval should be sought in advance and any shares acquired by exercise of the options should be held until at least one year after the non-executive director leaves the board. Holding of share options could be relevant to the determination of a non-executive director's independence (as set out in Provision B.1.1).

D.1.4. The remuneration committee should carefully consider what compensation commitments (including pension contributions and all other elements) their directors' terms of appointment would entail in the event of early termination. The aim should be to avoid rewarding poor performance. They should take a robust line on reducing compensation to reflect departing directors' obligations to mitigate loss.

D.1.5. Notice or contract periods should be set at one year or less. If it is necessary to offer longer notice or contract periods to new directors recruited from outside, such periods should reduce to one year or less after the initial period.

D.2: Procedure

Main Principle

There should be a formal and transparent procedure for developing policy on executive remuneration and for fixing the remuneration packages of individual directors. No director should be involved in deciding his or her own remuneration.

Supporting Principles

The remuneration committee should ~~consult~~take care to recognise and manage conflicts of interest when receiving views from executive directors or senior management, or consulting the ~~chairman and/or~~ chief executive about ~~their~~its proposals ~~relating to the remuneration of other executive directors~~. The remuneration committee should also be responsible for appointing any consultants in respect of executive director remuneration. ~~Where executive directors or senior management are involved in advising or supporting the remuneration committee, care should be taken to recognise and avoid conflicts of interest.~~

The chairman of the board should ensure that the ~~company~~committee chairman maintains contact as required with its principal shareholders about remuneration.

Code Provisions

D.2.1. The board should establish a remuneration committee of at least three, or in the case of smaller companies[22] two, independent non-executive directors. In addition the company chairman may also be a member of, but not chair, the committee if he or she was considered independent on appointment as chairman. The remuneration committee should make available its terms of reference, explaining its role and the authority delegated to it by the board[23]. Where remuneration consultants are appointed, they should be identified in the annual report and a statement made as to whether they have any other connection with the company.

D.2.2. The remuneration committee should have delegated responsibility for setting remuneration for all executive directors and the chairman, including pension rights and any compensation payments. The committee should also recommend and monitor the level and structure of remuneration for senior management. The definition of 'senior management' for this purpose should be determined by the board but should normally include the first layer of management below board level.

D.2.3. The board itself or, where required by the Articles of Association, the shareholders should determine the remuneration of the non-executive directors within the limits set in the Articles of Association. Where permitted by the Articles, the board may however delegate this responsibility to a committee, which might include the chief executive.

D.2.4. Shareholders should be invited specifically to approve all new long-term incentive schemes (as defined in the Listing Rules[24]) and significant changes to existing schemes, save in the circumstances permitted by the Listing Rules.

Section E: Relations with shareholders

E.2: Constructive Use of the AGM

Main Principle

The board should use the AGM to communicate with investors and to encourage their participation.

Code Provisions

E.2.1. At any general meeting, the company should propose a separate resolution on each substantially separate issue, and should in particular propose a resolution at the AGM relating to the report and accounts. For each resolution, proxy appointment forms should provide shareholders with the option to direct their proxy to vote either for or against the resolution or to withhold their vote. The proxy form and any announcement of the results of a vote should make it clear that a 'vote withheld' is not a vote in law and will not be counted in the calculation of the proportion of the votes for and against the resolution.

E.2.2. The company should ensure that all valid proxy appointments received for general meetings are properly recorded and counted. For each resolution, where a vote has been taken on a show of hands, the company should ensure that the following information is given at the meeting and made available as soon as reasonably practicable on a website which is maintained by or on behalf of the company:

- the number of shares in respect of which proxy appointments have been validly made;
- the number of votes for the resolution;
- the number of votes against the resolution; and
- the number of shares in respect of which the vote was directed to be withheld.

When, in the opinion of the board, a significant proportion of shareholders have opposed a resolution at any general meeting, the company should explain when announcing the results of voting what actions it intends to take to understand the reasons behind the vote result.

E.2.3. The chairman should arrange for the chairmen of the audit, remuneration and nomination committees to be available to answer questions at the AGM and for all directors to attend.

E.2.4. The company should arrange for the Notice of the AGM and related papers to be sent to shareholders at least 20 working days before the meeting.

Schedule A: The design of performance-related remuneration for executive directors

The remuneration committee should ~~consider whether the directors should be eligible for annual bonuses. If so, performance~~determine an appropriate balance between immediate and deferred remuneration. Performance conditions, including non-financial metrics as appropriate, should be relevant, stretching and designed to promote the long-term success of the company. Remuneration incentives should be compatible with risk policies and systems. Upper limits should be set and disclosed. There may be a case for part payment in shares to be held for a significant period.

The remuneration committee should consider whether the directors should be eligible for annual bonuses and/or benefits under long-term incentive schemes. Traditional share option schemes should be weighed against other kinds of long-term incentive scheme. Executive share options should not be offered at a discount save as permitted by the relevant provisions of the Listing Rules.

The remuneration committee should consider requiring directors to hold a minimum number of shares and to hold shares for a further period after vesting or exercise, subject to the need to finance any costs of acquisition and associated tax liabilities. In normal circumstances, shares granted or other forms of deferred remuneration should not vest, and options should not be exercisable, in less than three years. ~~Directors should be encouraged to hold their shares for a further period after vesting or exercise, subject to the need to finance any costs of acquisition and associated tax liabilities~~Longer periods may be appropriate.

Any new long-term incentive schemes which are proposed should be approved by shareholders and should preferably replace any existing schemes or, at least, form part of a well considered overall plan incorporating existing schemes. The total rewards potentially available should not be excessive.

Payouts or grants under all incentive schemes, including new grants under existing share option schemes, should be subject to challenging performance criteria reflecting the company's objectives, including nonfinancial performance metrics where appropriate. Remuneration incentives should be compatible with risk policies and systems.

Grants under executive share option and other long-term incentive schemes should normally be phased rather than awarded in one large block.

~~Consideration~~Schemes should ~~be given to the use of~~ include provisions that ~~permit~~would enable the company to ~~reclaim variable components in exceptional~~recover sums paid or withhold the payment of any sum, and specify the circumstances ~~of misstatement or misconduct~~in which the committee considers it would be appropriate to do so.

In general, only basic salary should be pensionable. The remuneration committee should consider the pension consequences and associated costs to the company of basic salary increases and any other changes in pensionable remuneration, especially for directors close to retirement.