

Corporate governance Developments in the UK

The UK Financial Reporting Council (FRC) has recently issued a revised UK Corporate Governance Code for listed companies and a UK Stewardship Code for institutional investors. Together, the two codes aim to raise governance standards in the wake of the financial crisis. This briefing sets out the key highlights with particular emphasis on the new UK Corporate Governance Code.

CIMA briefing July 2010

About CIMA

The Chartered Institute of Management Accountants, founded in 1919, is the world's leading and largest professional body of Management Accountants, with 172,000 members and students operating in 168 countries, working at the heart of business. CIMA members and students work in industry, commerce and not-for-profit organisations. CIMA works closely with employers and sponsors leading-edge research, constantly updating its qualification, professional experience requirements and continuing professional development to ensure it remains the employers' choice when recruiting financially trained business leaders.

CIMA is committed to upholding the highest ethical and professional standards of members and students, and to maintaining public confidence in management accountancy. CIMA has made an active contribution to the global corporate governance debate over many years. For further background, please visit www.cimaglobal.com/enterprise-governance

According to independent research conducted by the University of Bath School of Management, CIMA's syllabus and examination structure are the most relevant to the needs of business of all the accountancy bodies assessed. The need for good governance is an integral part of the CIMA syllabus.

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CIMA's perspective on governance

CIMA's view on governance can be summarised in terms of whether the following desired outcome is achieved:

Boards should be focused on the long-term sustainability of their business. They should be confident that their business models will deliver this – with appropriate risk mitigations as necessary - and that performance indicators and incentives reinforce the desired behaviours.

The new UK Corporate Governance Code

The UK Financial Reporting Council (FRC) issued a revised UK Corporate Governance Code for listed companies in May 2010. This followed a year of review and consultation. This briefing sets out the key highlights and provides some perspective on how it should contribute to improvements in governance practice. It also indicates how the debate will continue to evolve.

CIMA's viewpoint

CIMA welcomes the proposed changes as a considered and measured response to the governance challenges posed by the global financial crisis and we are hopeful that they will contribute to continuing improvements in corporate governance.

Ultimately, we believe that the FRC should judge the effectiveness of the code against whether the following desirable outcome is achieved: *Boards should be focused on the long-term sustainability of their business. They should be confident that their business models will deliver this – with appropriate risk mitigations as necessary - and that performance indicators and incentives reinforce the desired behaviours.*

So we particularly welcome the emphasis on long-term success in the new code.

In its recent discussion paper, *Enterprise governance – restoring boardroom leadership*, CIMA introduced a boardroom leadership model.

(www.cimaglobal.com/enterprisegovernance)

This showed all the key ingredients needed to restore boardroom leadership and emphasised that both behavioural and process issues were important – and indeed, were mutually reinforcing. We believe that the new UK Corporate Governance Code has successfully captured the spirit of this model.



Why have the changes to the code been made?

The FRC reviews the code regularly and last reviewed it in 2007. The plan was for a further review in 2010, but the impact of the global financial crisis changed all that. The UK government's decision in February 2009 to commission a review of governance in the banking sector (the 'Walker Review') meant that it made sense for the FRC to bring its own review forward.

When will the new code take effect?

It will apply to accounting periods beginning on or after 29 June 2010 so it will be some time before we actually see companies reporting on the new requirements.

What is the new code called?

Until this latest revision, the UK code was known as the Combined Code. This was one of those accidents of history that made sense at the time, but is no longer relevant. The name of the code has therefore been changed to the UK Corporate Governance Code.

Has the code changed significantly?

The main changes are more about emphasising key messages and behaviours rather than adding a long list of new requirements. In some cases, this has meant significant structural changes to the code in terms of rearranging some of the sections.

The review concluded that the code as it stood was broadly fit for purpose. There has, however, been widespread acceptance that the quality of corporate governance depends ultimately on behaviour not process and that there is a limit to what any regulatory framework can achieve.

The main changes are aimed at reinforcing existing aspects of the code and encouraging compliance with the spirit rather than the letter of the code. The FRC is keen for companies to move away from viewing the code as a compliance exercise. It wants more attention on the high level principles rather than the detailed provisions. The aim is to promote appropriate behaviour by boards and good communication between boards and shareholders. A key element is to emphasise the pivotal role of the chairman in ensuring good governance.

Nevertheless, there were two specific changes that have attracted comment:

- the annual re-election of all directors on the board – this is considered further below
- companies to include explicitly the gender mix of the board as a factor in considering new board appointments.

Key highlights

New introductory sections

The new preface emphasises the need to follow the spirit of the code and the importance of improving the relationship between companies and their shareholders. This lays the ground for the introduction of the complementary UK Stewardship Code which is regarded as part of one piece with the UK Corporate Governance Code.

Chairmen are also urged to report personally in their annual statements as to how the principles relating to the role and effectiveness of the board have been applied with the hope that this might address the 'fungus of boiler-plate governance reporting'. CIMA is undertaking further work with the Report Leadership Group to address best practice governance reporting – including what such a personal chairman's statement might look like.

There is also a section to clarify the 'comply or explain' principle. CIMA thinks that this is an extremely useful addition to the code as companies should be free to depart from code provisions if they can achieve the principles of good governance in other ways.

Leadership

The code now clarifies that the board is responsible for the long-term success of the company. The code also places particular emphasis on the role of the chairman by adding a new principle that *'the chairman is responsible for leadership of the board and ensuring its effectiveness on all aspects of its role'*. Another new principle clarifies that *'non-executive directors should constructively challenge and help develop proposals on strategy'*.

Risk

Risk is now mentioned more explicitly in the code. What used to be known as the 'internal control' principle has now been renamed 'risk management and internal control'. The principle has been revised to clarify that *'the board is responsible for determining the nature and extent of the significant risks it is willing to take in achieving its strategic objectives'* and that the board should maintain a sound system of risk management and internal control.

This now addresses what the FRC considers to have been a significant omission from previous versions of the code. As a follow up action, the Turnbull Guidance which focuses on this aspect of the code, will be reviewed later in 2010.

Remuneration

Performance-related pay should be designed to promote the long-term success of the company. CIMA has just published a report *Executive bonus schemes and their alignment with business sustainability* which looks at this issue in more detail.

New provisions

There are a number of new provisions in the code. In essence, these provide further detail on how a company should apply the high-level principles of the code. However, it is important to note that while we often talk about a new provision imposing new requirements, all the provisions are subject to 'comply or explain'. This means that a company may choose not to comply with a specific provision, but it will need to give a reasoned explanation in its corporate governance report.

Here are the key new provisions:

- The chairman should agree and regularly review a personalised approach to training and development with each director.
- Evaluation of the board should be externally facilitated at least every three years.

This will only be applied to FTSE350 companies due to concerns over the availability of board evaluation services.

- Annual re-election of all directors.

This has been the most controversial change in the code. Supporters of the change, which included a majority of institutional investors who responded, felt that it would promote better engagement between the board and shareholders. The argument is that if boards are receptive to shareholder concerns, then the situation should not arise where the shareholders feel compelled to oust the board en masse at the annual general meeting. Those who argued against the change, such as listed companies, felt that it would lead to short-termism and create the potential to destabilise the board.

CIMA welcomes the intention of the FRC to monitor the impact of this revised provision as we do have concerns about boards coming under pressure from shareholders to pursue the 'latest fad' when it may be in the company's long-term interest to follow a more cautious strategy.

- *'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.'*

CIMA welcomes the inclusion of this provision and in particular, the emphasis on long-term value. We note that the FRC are encouraging companies to include this description in the same part of the annual report as the Business Review which is required under the Companies Act 2006. In addition, the FRC has indicated that companies that are properly applying the ASB's voluntary Reporting Statement on the Operating and Financial Review (OFR) are already providing the information; the FRC has therefore revised the wording of this new code provision to mirror that of the Reporting Statement to reduce confusion and duplication.

- 'The board should satisfy itself that appropriate systems are in place to identify, evaluate and manage the significant risks faced by the company'.

This reinforces the more explicit inclusion of risk in the new code.

- Remuneration

The provisions relating to remuneration have been amended to clarify that payouts under incentive schemes should be subject to non-financial performance criteria where appropriate and compatible with the company's risk policies and systems.

The role of investors – the new UK Stewardship Code

There have been concerns expressed about the quantity and effectiveness of engagement between institutional investors and company boards.

The Walker Review of governance of banks and other financial institutions made a number of recommendations relating to institutional investors. These included the proposal that the FRC's remit should be extended to cover best practice in stewardship and that the FRC should ratify the existing Code on the Responsibilities of Institutional Investors (prepared by the Institutional Shareholders' Committee). It should operate this code as a Stewardship Code on a 'comply or explain' basis and review it on a regular basis.

As a consequence of this recommendation and subsequent consultation, the FRC issued a UK Stewardship Code in July 2010. The FRC sees the UK Stewardship Code as complementary to the UK Corporate Governance Code because it can help to strengthen the link between governance and the investment process and so help to lend greater substance to the 'comply or explain' concept.

CIMA's viewpoint

CIMA supports the code as a useful contribution to the overall 'governance toolkit', while also recognising that it is essential to be realistic as to what such a code is likely to achieve. We have therefore urged careful consideration of the costs and benefits of operating such a code.

Basically, there is a need to cast the net wider to address what is a complex problem. There is evidence, for example, that some shares are held for a matter of seconds. So, it is important to assess the extent to which the phenomenon of 'ownerless corporations' is a reality and the consequent implications – especially for the public interest. This could then help to generate possible options such as incentives to support greater investor engagement.

CIMA is also of the view that better company reporting can contribute to improved investor engagement and has been involved in this field for some time through its membership of the Report Leadership Group with PricewaterhouseCoopers and Radley Yeldar. The aim of the group is to improve narrative and financial reporting to make it more relevant and informative to investors. This year, the group is focussing particularly on governance reporting. Further information on this is provided below.

The UK Stewardship Code in brief

The code comprises seven broad principles, supported by guidance. These cover issues such as disclosure of engagement policy, collective engagement and reporting on stewardship and voting activities.

The code is addressed in the first instance to those firms who manage assets on behalf of institutional investors. However, the FRC is also hoping that foreign investors will commit to the code. Given that they are believed to own around half of all UK shares, their more active engagement could have a significant impact.

The question is therefore whether the code will prove to be effective. However, supporters feel that it is a step, even if only a small one, in the right direction and sends out a clear message that the UK is committed to the highest standards of good governance throughout the investment chain. Nevertheless, the FRC is likely to face a significant challenge in achieving comprehensive take-up of the code.

It's a start, most would say. But the culture of neglect that arguably infects the big institutions that own our biggest businesses (on behalf of us, because it's our savings that they're investing) won't quickly or easily be cured.

BP, banks and shareholder neglect, Peston's Picks, 2 July 2010 (Robert Peston's blog on www.bbc.co.uk)

Where next for governance?

Good governance is a journey, so the debate will continue to evolve. The UK is widely regarded as a world leader in governance development, so these new codes will be keenly studied across the world.

In our initial submission to the FRC, we said that the FRC has a potent role to play in championing good governance and that it could commission and disseminate appropriate research, for example in considering best practice in provision of information to boards. A useful way of doing this is through the medium of case studies which provide examples of best practice and answer the question 'what does good governance look like?'

CIMA also believes that it is absolutely essential that the board is connected effectively to the business in terms of delivering successful performance as we are of the view that it was a lack of such connectivity that contributed to some of the recent corporate failures – this is an area that we will continue to focus on. Other key areas are:

- The ethical dimension of business and how this can be fully embedded.
- Learning from governance practices across the world. CIMA has been comparing western and Asian governance practices as part of its work for the World Congress of Accountants 2010 in Malaysia and we believe that there are valuable lessons to be learnt.

Current projects

- As a member of the Report Leadership Group, CIMA is working with PricewaterhouseCoopers and Radley Yeldar to develop best practice in governance reporting (www.reportleadership.com). The objective is to provide information that will meet investors' needs rather than being compliance driven and boilerplate in nature.
- CIMA is a member of the Tomorrow's Company Good Governance Forum which is working to produce further thought leadership on various aspects of the governance agenda including behavioural issues and the role of the board in strategy (www.tomorrowcompany.com).
- The Institute of Chartered Secretaries and Administrators (ICSA) has been commissioned by the FRC to update earlier supplementary good practice guidance (the Higgs Report) which addresses issues such as the role of the non-executive director in more detail. The focus is improving board effectiveness and CIMA will continue to input into this project (www.icsa.org.uk).

Where can I find a copy of the new UK Corporate Governance Code and the UK Stewardship Code?

They can be downloaded from the FRC's website at www.frc.org.uk

Relevant CIMA publications

- *Enterprise governance – restoring boardroom leadership, 2010*
- *Incorporating ethics into strategy: developing sustainable business models, 2010*
- *Executive bonus schemes and their alignment with business sustainability, 2010*
- *Report Leadership – tomorrow's reporting today* (with PWC and Radley Yeldar), 2006

All are available from www.cimaglobal.com/resources

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