Corporate Governance Update: Remuneration and Risk Management

September 25, 2014

Two key publications have recently been issued which are relevant to UK listed companies in terms of their approach to corporate governance policies on remuneration and risk management.

The first is the National Association of Pension Funds' report on the 2014 Annual General Meeting season for FTSE 350 companies. The focus of this report is on the recent regulatory changes to remuneration reporting and auditor reports, and its own 2013 "Remuneration Principles for Building and Reinforcing Long-term Business Success".

The second is the Financial Reporting Council's 2014 UK Corporate Governance Code. The revisions made to the 2012 edition of the Corporate Governance Code closely follow the proposals that were set out by the FRC in its April 2014 consultation paper. The changes largely relate to directors' remuneration and risk management, and are supported by updated FRC Guidance.

NAPF 2014 AGM Report

The NAPF conducts an annual monitoring exercise of the preceding AGM season for UK quoted companies to determine key investor trends and issues. Its findings are then published in an annual report. The **NAPF 2014 annual report** was published on 16 September 2014.

Remuneration Reporting

A new remuneration reporting regime for UK quoted companies came into force on 1 October 2013. Broadly, this regime requires UK quoted companies to produce a directors' remuneration report comprising the following two sections:

- **Remuneration Policy** which sets out the company's future remuneration policy and potential payments to directors. This policy is subject to a binding shareholder vote (by way of ordinary resolution) at least once every three years.
- **Annual Report on Remuneration** which sets out how the company intends to implement the remuneration policy in the next financial year, and details of each director's remuneration in the last financial year. This report is subject to an advisory shareholder vote on an annual basis.

The NAPF report observes that, in terms of voting on the directors' remuneration report, it has been a "quiet and uneventful season" with a relatively low level of shareholder dissent. Where shareholders have dissented on the directors' remuneration report, the NAPF notes that it is encouraged by the companies' response as many have indicated that they fully understand and will take account of shareholders' concerns.

On the quality of the annual remuneration report itself, the NAPF acknowledges that improvements have been made but notes that more needs to be done by companies to "boost transparency". In particular, the NAPF observes that these reports should set out why the remuneration level for a company's directors is appropriate for that company's long term strategy.

Audit Reporting

A company's auditor is required to produce a report to the company's shareholders on the annual accounts of the company. On 4 June 2013, the FRC published a set of revisions to ISA (UK and Ireland) 700 (the independent auditor's report on financial statements). For entities that are required to apply the UK Corporate Governance Code and for financial statements for periods commencing on or after 1 October 2012, these revisions require an auditor to describe its assessment of the risks of material misstatements in the financial statements, an explanation of how the auditor applied materiality in relation to the audit and information on the scope of the audit.

The NAPF report observes that the quality of auditor reports for the 2014 AGM season has not been consistent. The report notes that:

- the most useful auditor reports are those which discussed key risks and the work done to evaluate them, and sets out the auditor's views on the soundness of the company's estimates;
- auditor reports should equip investors with information to engage with the company's management and directors on the audit process; and
- auditor reports should not contain boilerplate language on areas of audit focus as this creates confusion on the significance of the risks disclosed in the report.

ISA (UK and Ireland) 700 was revised again by the FRC in September 2014 to reflect the 2014 Code, and **these revisions** will apply to financial years beginning on or after 1 October 2014.

Remuneration Principles

In November 2013, the NAPF published a set of guidelines entitled: "**Remuneration Principles for Building and Reinforcing Long-term Business Success**" which sets out the NAPF's expectations of companies' remuneration structures and practices. The NAPF report notes that it is encouraged by the direction that companies' remuneration structures are heading in terms of implementing these principles, and urges investors to provide companies with room to do so.

2014 UK Corporate Governance Code

Under the UK Listing Rules, companies with a premium listing of equity shares (whether incorporated in the UK or otherwise) are required to make a statement in their annual reports on how they have applied and complied with the UK Corporate Governance Code. The UK Corporate Governance Code was last published by the FRC in September 2012 and has recently been revised in the light of various legislative changes, including those relating to directors' remuneration reporting.

The key changes made to the 2012 Code are set out below. The **2014 Code** was published on 17 September 2014 and will apply to financial years beginning on or after 1 October 2014.

Remuneration

- Executive directors' remuneration must be designed with the company's long-term success in mind, and the performance-related aspects of such remuneration must be "rigorously applied".
- Arrangements should be established to enable companies to withhold or retrieve variable pay where appropriate in respect of performance-related remuneration for executive directors.
- There should be a balance between fixed and performance related remuneration, and immediate and deferred remuneration.
- Remuneration incentives should be compatible with risk policies and systems.

- For share-based remuneration, the remuneration committee should consider requiring directors to hold a minimum number of shares and to hold them for a further period after vesting or exercise (including for a period after leaving the company).

Risk Management and Going Concern

- **Accounting Basis Assessment** - Directors should state in financial statements whether they consider it appropriate to use the going concern basis of accounting. The directors should also identify any key uncertainties in respect of the company's ability to continue to do so over a period of at least 12 months from the date of approval of the relevant financial statements.
- **Risk Assessment Confirmation** - Directors should confirm in the annual report whether they have robustly assessed the company's principal risks and describe how such risks are being addressed.
- **Long-term Viability Statement** - Directors should explain in the annual report whether they reasonably expect that the company will be able to continue its operations for a specified period of time. The FRC expects that this statement will look at a period significantly longer than 12 months.
- **Risk Management Review** - Directors should review the company's risk management and internal control on an annual basis (at least) and report on such review in the annual report.

Shareholder engagement

- Companies should explain when publishing general meeting results how they intend to engage with shareholders when a significant percentage of them have voted against any resolution.

Risk Management, Internal Control and Related Financial and Business Reporting

In addition, the FRC has replaced the current editions of its "Internal Control: Revised Guidance for Directors on the Combined Code" and "Going Concern and Liquidity Risk: Guidance for Directors of UK Companies" with a new guidance note: "**Guidance on Risk Management, Internal Control and Related Financial and Business Reporting**". The purpose of this note is to assist directors in applying Section C of the 2014 Code. Specifically, this note provides guidance on how companies can comply with the risk management aspects of the 2014 Code including in relation to the accounting basis assessment and the long term viability statement.

Concluding Remarks

Looking forward to the 2015 AGM season, companies should bear in mind the NAPF's comments on companies' implementation of the new remuneration reporting. Whilst the 2014 AGM season may have been relatively uneventful in terms of shareholders' dissent, this trend may not persist in the 2015 AGM season. Specifically, the NAPF has warned in its report that the relatively "quieter" 2014 AGM season may be because investors have given companies the "benefit of the doubt" in light of the new regime.

The 2014 Code has introduced more restrictions on directors' remuneration and more onerous reporting requirements. Companies will have to put their processes in place (if they have not already done so) to deal with these requirements as they will apply to financial years beginning on or after 1 October 2014.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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