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Ten reflections on the 2018 Code

2018 Corporate governance reforms
Audit Committee Institute

In our publication The UK Corporate Governance Code we provided a summary of the 2018 revisions to the UK Corporate Governance Code – a shorter, sharper, Code focused on the importance of long-term success, sustainability and the stakeholder relationships necessary to achieve this. In this publication we explore a number of the changes through the lens of value creation rather than compliance.

1. "The new Code applies to accounting periods beginning on or after 1 January 2019." **[Introduction to the Code]**

While the Introduction to the Code stresses the importance of the Code Principles and the need to articulate clearly how those Code Principles have been applied, the Compliance statement is still important. Listing Rule 9.8.6(6)(b) requires that Premium listed companies disclose the extent of their compliance throughout the accounting period which for many companies means that, if they are to comply in full, they will need all relevant processes and procedures in place from 1 January.

2. "The 2018 Code focuses on the application of the Principles. ... At the heart of this Code is an updated set of Principles that emphasise the value of good corporate governance to long-term sustainable success. ... Achieving this depends crucially on the way boards and companies apply the spirit of the Principles." **[Introduction to the Code]**

It is important to report meaningfully when discussing the application of the Principles and to avoid boilerplate reporting. The focus should be on how these have been applied, articulating what action has been taken and the resulting outcomes. High-quality reporting will include signposting and cross-referencing to those parts of the annual report that describe how the Principles have been applied. This will help investors with their evaluation of company practices.

3. "The board should establish the company's purpose, values and strategy, and satisfy itself that these and its culture are aligned. All directors must act with integrity, lead by example and promote the desired culture." **[Code Principle B]**

'Purpose and values' are not merely "motherhood and apple pie" – they drive tangible behaviours and as such, should be owned by the board. Think through what 'purpose and values' means for the company and how its people should behave. Ask the executive to provide a coherent explanation and consider whether their view is aligned to that of the board. If the company doesn't have a clearly articulated purpose, work it through with the executive team – all the time being mindful of the company strategy and the views of employees, investors and other key stakeholders.

4. "The board ... should describe in the annual report how opportunities and risks to the future success of the business have been considered and addressed, the sustainability of the company's business model and how its governance contributes to the delivery of its strategy." **[Code Provision 1]**

Corporate governance reporting should be *"in the context of the particular circumstances of the company"* so articulate how the board's work supports the corporate strategy and provide linkage with other parts of the annual report – particularly the Strategic Report and other complementary information – so that shareholders can effectively assess the quality of the company's governance arrangements, and the board's activities and contributions. This should include providing information that enables shareholders to assess how the directors have performed their duty under section 172 of the Companies Act 2006 (the Act) to promote the success of the company.

5. "The board should assess and monitor culture. Where it is not satisfied that policy, practices or behaviour throughout the business are aligned with the company's purpose, values and strategy, it should seek assurance that management has taken corrective action. The annual report should explain the board's activities and any action taken. In addition, it should include an explanation of the company's approach to investing in and rewarding its workforce." **[Code Provision 2]**

The board need assurance that people fully understand the desired culture, and feel empowered to 'live' it day-to-day in their decision-making. This requires some form of measurement whether that be through staff surveys, internal audit work or simply having conversations with people in the business about things that are on their minds.

It is important that the desired culture is defined and owned by both the board and the executive team. Defining culture may involve affirming the organisation's purpose, values and the behaviours that are seen to embody these; as well as linking these through to the business strategy and its long-term goals. Also ensure key business processes (including hiring, firing and reward) are aligned with the desired culture and embed culture in to decision-making processes. An organisation is not truly living its values until it costs money.

6. "The board should understand the views of the company's key stakeholders and describe in the annual report how their interests and the matters set out in section 172 of the Companies Act 2006 have been considered in board discussions and decision-making. The board should keep engagement mechanisms under review so that they remain effective." **[Code Provision 5]**

Section 172(1) states that a director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to the likely consequences of any decision in the long term and the interests of the company's employees; the need to foster the company's business relationships with suppliers, customers and others; and the impact of the company's operations on the community and the environment.

Understanding who the company's key stakeholders are and factoring their views into board decision making is a business fundamental. Boards may be doing this already, but recent headlines show that 'surprises' do happen and therefore a more structured approach to discharging the board's section 172 duties might lead to a better quality debate and improved stakeholder management.

It's not yet clear how boards will report in practice, but the starting point is likely the identification of both the key stakeholders and the key decisions made by the board.

Remember, the director's job is not to balance the interests of the company with those of other stakeholders. Rather it is to weigh up all the relevant factors in considering the course of action that will best lead to the success of the company. This will inevitably mean that there are times when certain stakeholders are adversely affected.

7. "For engagement with the workforce, one or a combination of the following methods should be used:
- a director appointed from the workforce;
- a formal workforce advisory panel;
- a designated non-executive director."

[Code Provision 5]

In addition to the three methods explicitly addressed in the Code, there are other – perhaps existing - mechanisms which might be deployed. For example, board composition, board induction and professional development, 'walking the floors', staff surveys, social media and formal agenda items are all relevant to understanding the views of employees. Use the Code as an opportunity to sense check what the company is already doing and whether it is covering all the relevant angles e.g., incentive plans, work-life balance, resilience to change, communications and alignment with the board's chosen strategy and values.

Think about how getting better sight over the views of the workforce view will broaden the board's understanding, offer different perspectives and build trust.

8. "The chair should be independent on appointment ..." **[Code Provision 9]**

"The chair should not remain in post beyond nine years from the date of their first appointment to the board. To facilitate effective succession planning and the development of a diverse board, this period can be extended for a limited time, particularly in those cases where the chair was an existing non-executive director on appointment. A clear explanation should be provided." **[Code Provision 19]**

This provision effectively limits the tenure of the board chair to nine years of board service – though the provision does offer some flexibility to facilitate effective succession planning and the development of diverse boards. While such flexibility is to be welcome, it does introduce a degree of uncertainty (and potential inconsistency) as boards grapple with the question as to whether they have, or have not, complied with the Provision. Notwithstanding that a clear explanation is required in *all* circumstances where the chair's board tenure exceeds nine years, different boards may reflect the same circumstances very differently in their Code compliance statements.

Some have suggested that chairs 'caught' by this new provision might step aside but still sit on the board as a non-independent non-executive director. This would have the advantage of retaining a degree of corporate memory, but could potentially create a difficult environment for the incoming chair.

9. "There should be a formal and rigorous annual evaluation of the performance of the board, its committees, the chair and individual directors. The chair should consider having a regular externally facilitated board evaluation. In FTSE350 companies this should happen at least every three years." **[Code Provision 21]**

"The annual report should ... how the board evaluation has been conducted, the nature and extent of an external evaluator's contact with the board and individual directors, the outcomes and actions taken, and how it has or will influence board composition." **[Code Provision 23]**

There are two significant changes here. First, chairs of *all* boards are now asked to consider having a regular externally facilitated board evaluation – previously it was just FTSE350 boards that were expected to make use of external facilitation. While there is a financial cost involved, we believe the benefits of regular externally facilitated board evaluations can far outweigh the costs – which in any event should be proportionate to board size and the complexity of the governance arrangements.

Secondly, the 'required' disclosures now go far beyond a discussion of the evaluation process in asking for transparency around the outcomes and actions taken. For many companies – particularly those towards the top of the FTSE – this is not new, so there are good examples to review for those getting to grips with what might be considered a sensitive area.

10. "At least half the board, excluding the chair, should be non-executive directors whom the board considers to be independent." **[Code Provision 11]**

While some Code relaxations still exist for smaller companies, the relaxation for smaller companies needing only two independent non-executive directors has been removed. [A smaller company is one below the FTSE350 throughout the year immediately prior to the reporting year.]

Companies could use the 'comply or explain' framework to rationalise non-compliance with this Provision, however, it is likely that, many will feel compelled – if only by the perception that some proxy voting agencies and institutional investors are unwilling to engage constructively around areas of non-compliance – to hire additional non-executive directors. There will be a financial cost to this, but equally this could act as a catalyst for increased board diversity.

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