



September 2018

## The new Code (again): spotlight on the Principles

In last month's bulletin we looked at some of the changes to the Code which are kicking in next year – and how boards might get value from responding to the new requirements. But we didn't go into detail on a major change in the expectations around the Principles: this is in fact a fundamental shift that could have a wide-ranging impact on how boards work.

A lot of what follows refers to the detailed wording of the Code, so we're at risk of being accused of writing for "governance geeks"!

(But this is no doubt a large proportion of our readership...) Even though it might be a bit dry, this really is a shift that all directors need to absorb. We are focusing deliberately here on the Annual Report – but some things will need to change if you're to have a good story to tell.



"Comply or explain" is often referred to as the basis of the Code – but this has only ever been (and continues to be) the case for the Provisions. For the Main Principles, board have been expected to apply them and report on how they did so. But the new Code has shifted the balance. As the FRC states: "the 2018 Code focuses on the application of the Principles" p2) and these are "at the heart of this Code" (p1). The Supporting Principles have gone – and the Principles are given a stronger emphasis. And, crucially, the expectations of how boards explain the way they go about applying the Principles represents a seismic shift (if it's not over the top to attach this term to corporate governance). Boards need to consider the implications carefully. Here we share a few thoughts on what "good practice" might look like, and what boards might aim to do – and responses that should be avoided, no matter how strong the temptation to succumb to the hope that not much has changed.

### Good practices to consider...

Take a step back – individually and collectively as directors – and look at the changes to the wording in the section "reporting on the Code". Make sure you've fully appreciated the implications of the shift away from the very limited wording of the 2016 Code ("apply...and report to shareholders on how they have done so").

### Things to avoid...

It's now much more than "comply or explain" on the (more limited) Provisions. It's a question of applying the Principles – and describing how you've done it in enough detail for investors to understand the approach to governance and assess how the Principles have been applied.

## Good practices to consider...

## Things to avoid...

Think through the implications of some wording in the Code's preamble that can easily get overlooked: "Achieving [effective reporting on the Board's contribution] depends crucially on the way boards and companies apply the spirit of the Principles".

Going down the boilerplate route. You might have got away with it in the past but it's becoming a lot riskier. The sentiment behind the new Code means that bland, standard wording in the governance report is going to look even less impressive. Sceptics will argue that investors still won't take much notice – and sadly that might still be true. But they aren't the only readers: the political and social winds have changed. Those companies sticking to the standard, (cautious? lazy?) wording will increasingly stand out, and not in a good way.

Work out how the application of the Principles, the fuller Code and "the governance of the Company" contribute to the achievement of "long-term sustainable success and... wider objectives" (p1). Because that's the story that increasingly will need to be told in the governance report. That means a long, hard, objective look at the question: how much difference does the Board really make?

Churning out the same old stuff about the Board's role and activity which gives the impression that it hasn't given much thought to what its impact is. Or maybe it did give it a lot of thought, but something vaguely well-meaning was all it could come up with.

The Code insists that: "Reporting [should be] in the context of the particular circumstances of the company." So set out how the Board's work reflects the evolution of the Company, the stage it has reached in delivering its strategy, its place in its markets, reinforcing its values...

Making your governance sound just the same as everybody else's. Organisations pride themselves on being different – and that typically has to be the basis of a competitive strategy. If your governance is really supporting the achievement of strategic objectives, then some of that uniqueness ought to be apparent in the governance report. And get the NEDs to provide the challenge on how far that is achieved.

Look more at the outcomes of board governance by pinning down "how the Board has met objectives and achieved outcomes through the decisions it has taken". That means looking at particular big decisions it has taken and what happened next.

Going for "bland" on the basis that (or using the excuse that) any exposure of the board's decision-making approach is exposing innermost secrets and putting the crown jewels at risk. A few well-crafted descriptions in a case-study format can go a long way in helping investors and other stakeholders understand how this board is working and how it's been living the Principles to enhance board and exco decision-making.

Tie descriptions to the actions that resulted. "It is important to report meaningfully when discussing the application of the Principles... how they have been applied, articulating what action has been taken and the resulting outcomes."

Describing the actions in such a high-level, or even airy-fairy, way that they appear devoid of intent.

## Good practices to consider...

Work at integrating the governance report with the rest – and picking up on board governance elsewhere if it's clearly relevant: "High quality reporting will include signposting and cross-referencing to those parts of the Annual Report that describe how the Principles have been applied. The new Code also expects that: "Governance reporting should relate coherently to other parts of the Annual Report – particularly the Strategic Report... so that shareholders can effectively assess the quality of governance and the Board's activities and contributions."

Give more explicit attention to Section 172 (the responsibility to consider other stakeholders' interests), both in the report and in the boardroom. This is now so prominent on the political agenda that you need to give a convincing and credible description of how these responsibilities are met in practice. That'll be quite a bit easier if you've actually tackled it head-on in the boardroom.

## Things to avoid...

Treating the governance report as a standalone section. That might be convenient when you want to put to bed a chunk of the Annual Report well before year end. But the Code asks you to highlight how governance is having an impact – and that will mean clear signposting to other parts of the Annual Report, those that describe the business, risks, outlook etc that have (we hope!) been impacted by governance.

Continuing with the previously wide-held presumption that s172 is a harmless bit of political correctness which will be addressed naturally as part of normal board discussion and decision-making. In the present political climate, reporting which could be construed as conveying a lack of attention will merely give the press and politicians a stick to beat you with.

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BOARD REVIEW

