Practical Governance

Issue Number 104 **24 April 2009**

Focus On …

The governance agenda for the summer – bolting the stable door...

Reeling from the horrors of the banking crisis the authorities are falling over themselves to come up with initiatives to review governance and risk management with particular reference to the financial sector, and later this summer and autumn we can expect to see some results. Indeed it is already happening to some extent.

The FSA has taken the initiative by announcing that it intends to 'make people scared' by, amongst other things, a programme of inspection of financial institutions and especially their boards. It is making a long list of appointments with executive and non-executive directors of financial institutions and interviewing them with (judging from anecdotal reports to your editor) a fair degree of rigour to find out whether they understand the institutions they are serving. In the meantime, the Government, via the Treasury, has set up a review of banking governance under the chairmanship of Sir David Walker, which is due to report this autumn. Richard Smerdon from *Practical Governance* has submitted a recommendation to that review to the effect that the scope of directors' duties under the *Companies Act* 2006 should be widened to require directors of deposit taking entities to have specific regard to the interests of depositors when taking decisions allegedly in the interests of members as a whole.

In addition, the FRC (as we report below) is looking at the Combined Code to see what changes should be made to reflect the crisis.

Finally, Lord Myners has waded in with some trenchant ideas of his own: for example, boards should appoint a 'devil's advocate', directors should be required to be sent on regular training courses to refresh their thinking, the whole concept of 'shareholder value' should be rethought , and perhaps non-executives should be given their own secretariat and technical specialists. All these are good initiatives – even if the horse bolted long ago there's a chance we may be able to recapture it in time for the next boom. ■

STRATEGIC PARTNER

THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND AND WALES

CONTENTS

1 Focus On …
x Corporate Responsibility
x Corporate Governance
x Financial Reporting
x Company Law
x Banking Regulation

CONSULTANT EDITORS

Richard Smerdon
Executive Editor

Neil McKim
Executive Editor

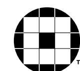
EDITOR

Susan Baker
susan.baker@cch.co.uk

Access our online services at:
www.cch.co.uk

To purchase a subscription or for queries, call us on:
0844 561 8166

Gee customers should contact the dedicated queries helpline on:
0845 050 8942



CCH
a Wolters Kluwer business

In Depth

CORPORATE RESPONSIBILITY

For richer and poorer: corporate responsibility and the economic downturn

Jennifer Zerk

The business case for corporate responsibility (or 'CR') faces its toughest test yet as the economic downturn starts to bite. Although the idea that businesses should be responsible corporate citizens is not new, it is only in the last ten years or so that CR has become a management topic in its own right. That same period has seen the growth of an army of CR consultants and commentators who, by this time last year, were declaring that the 'mainstreaming' of CR was nearly complete. Whether they were right or not is about to become much clearer, as staff are laid off and budgets for 'non-core' activities start to shrink.

Intuitively, it makes sense that responsible, well-run companies that pay attention to community, employee and environmental interests would tend to do better over the long term. This is implicit in the idea of 'enlightened shareholder value', which runs through the new UK companies legislation. And there is plenty of empirical evidence in support of a positive correlation between CR (insofar as this can be measured) and good financial performance. Business in the Community (BITC) has recently published research that they say demonstrates that companies that have consistently participated in their Corporate Responsibility Index have outperformed the FSTE 350 on total shareholder return between 2002–2007 by between 3.3 per cent and 7.7 per cent per year. But pinning down the precise reasons for this correlation – and precisely how and where CSR adds value – is harder to do.

So is there any sign that companies are back-tracking on their CR commitments now that things are getting that much tougher? There are already signs that corporate giving – both financial and in-kind – has been badly affected, especially from the financial sector. Although it is too early to tell precisely what the impact will be, charities that rely heavily on corporate donors are understandably very concerned.

Extra-curricular philanthropic activities – such as volunteering on community projects – seem most at risk. But beyond this, the picture is more mixed. CR managers are not about to become extinct, although within companies a certain amount of rationalisation and restructuring is taking place. And specialist recruitment companies are beginning to notice a change in the kinds of CR and sustainability positions becoming available. 'While companies are scaling back their social and fundraising roles, they are becoming much more focused on climate change and sustainability,' says Toby Young of Acre Resources.

Of course the pressure points will vary from sector to sector. An important CR driver for supermarkets, for example, has been the steady growth in public awareness about 'cruel' or 'unethical' products. But a recession can change all that. And when hard-pressed customers start to shift their attention from 'ethical' products back to 'cheap', companies have to balance their ethical aspirations against the danger that they may go out of business altogether (see Stefan Stern, FT, 3/2/09).

It is still early days, but so far there does not seem to be a fundamental change in what business leaders are saying about CR – in public at least. 'Of course companies must run things tighter in a recession' says Patrick Mallon, BITC's Benchmarking and Reporting Director, 'but CR is not an overhead, but a value creator'. Managers who realise this, he argues, will be taking the opportunity to think very carefully about how they do business: how they can become more energy efficient, for example, and how they can make things better for staff. 'There is a huge responsibility on senior managers now to get out there and talk to their own people', says Mallon. 'But it

Contact us: **0844 561 8166**

In Depth (cont'd)

isn't all doom and gloom. There is a potential [financial] upside, if companies are prepared to look at the environmental and social consequences of what they do and see the positive elements of doing business differently.'

Many companies have discovered this already. As far as making money from CR is concerned, there were plenty of examples on display at BITC's latest awards ceremony; including an energy efficiency toolkit launched by EDF which, according to that company, has brought in £30 million worth of new contracts, and Kraft's commitment to source all its coffee beans from Rainforest Alliance Certified farms, which, although not yet fully implemented, has reportedly already resulted in a 40 per cent increase in sales of one of its leading coffee brands.

At the same time, there are undoubtedly economies to be made in how companies communicate their CR performance. While few (if any) leading brands are likely to abandon CR reporting altogether, there are savings to be made in how reports are produced and distributed. 'This means doing more over the web and simplifying design', says Simon Propper of CR strategy and communications firm, Context. Costly external assurance arrangements will also be under review. While these are still seen by many as crucial to the credibility of a CR report, 'assurance providers are going to be under pressure to give better value for money', says Propper. Other trends include greater use of internal audit processes, of niche CSR assurance providers and of stakeholder groups to challenge and test corporate claims. These all have the potential to save money and improve the quality of reports, although Patrick Mallon says that it is important, in gathering together tons of data, that managers do not lose sight of what CR reports are actually for. 'What we need from CR reporting is real insight into how decisions are made, and the checks and balances in place,' he says.

Of course, when weighing up the value or otherwise of different CR activities, no-one should lose sight of the fact that this particular recession has its root causes in corporate irresponsibility on a monumental scale. Obviously, there will have to be changes in how the financial services sector works, although David Logan of Corporate Citizenship warns against taking a stick to the economy as a whole. 'There are clearly problems of governance in the financial sector, where greed is trap that is easily fallen into', he says, 'but the real economy is constrained by the need for consistent reputation, the need for repeat business and the realities of doing business'.

But public fury over corporate greed and ineptitude is not confined to banks, as three auto industry executives found out recently when they arrived in Washington by private jets to request a taxpayer funded bail-out. Confidence in companies has been badly damaged, faith in the deregulatory agenda shattered. As well as looking again at their own risk management processes and business plans, companies also need to figure out how to re-build trusting relationships with their employees, with investors, with governments and with the communities and customers they serve. Clearly, corporate responsibility plays a part at every stage.

Jennifer Zerk is a former City lawyer, now a writer, researcher and business consultant specialising in the legal aspects of corporate responsibility

www.jenniferzerkconsulting.com.

Winners of the second annual CR Reporting Awards announced

The winners of the second CR Reporting Awards 2008 (CRRA '08) were announced at an awards ceremony on Friday, 27 March 2009, at the MayFair Hotel in London. The awards were presented by Richard Howitt MEP. Details can be found at *www .corporateregister.com/crra/*.

Access subscriptions and services online at: **www.cch.co.uk**

In Depth (cont'd)

The CR Reporting Awards are the only annual, global awards for Corporate Responsibility (CR) reporting. They identify and acknowledge the best CR reports across nine categories, five of which are for specific 'transparency aspects', such as carbon disclosure.

- Best Overall Report – Vodafone Group
- Best 1st Time Report – Virgin Media
- Best SME Report – Ecologic Designs Inc
- Best integrated report – Novo Nordisk A/S
- Best Carbon Disclosure – Royal Dutch Shell plc
- Creativity in Communications – Coca-Cola Enterprises Inc
- Relevance & Materiality – Vodafone Group plc
- Openness & Honesty – Co-operative Group Limited
- Credibility through Assurance – Vodafone Group plc

The CR Reporting Awards are managed by CorporateRegister.com, the CR resources website and providers of the world's largest online directory of CR Reports. Over 2,000 companies with reports published between September 2007 and September 2008 (and profiled on CorporateRegister.com) were invited to enter. To make this year's voting more manageable, entry to certain categories was limited.

All 26,000 registered users of CorporateRegister.com were entitled to vote, and voting took place online between October 2008 and January 2009.

CorporateRegister.com's Managing Director Paul Scott said: 'For the second year, the thousands of votes entered for the CR Reporting Awards have demonstrated the global interest in corporate responsibility reporting. There is momentum behind CR reporting. In the midst of the current economic gloom this reflects a climate of optimism and hope.'

Prior to the awards ceremony a high-profile daytime programme of CR debates was held at The Royal Institution of Great Britain, attended by representatives of companies who had entered into the awards and key stakeholders from the sustainable finance, regulatory and NGO communities.

The debate agenda was attendee-driven, with delegates prioritising a list of 12 themes. The more popular themes reflect a growing interest in the role of CR reporting in financial markets, particularly in times of economic hardship:

- Gold or gilt? However measured, CR reporting can never match financial reporting
- Bespoke materiality please!
- 'Materiality' can only be defined by engaging a company's stakeholders
- Wrong vehicle, wrong way! Companies still don't communicate 'sustainability' effectively to investors
- Regulate or fail! CR reporting must be mandatory to effect real change
- Has the moment passed? CR reporting will decline in importance in the context of the world economic crisis

For more details go to *www.corporateregister.com*

CORPORATE GOVERNANCE

FRC to review the Combined Code

The Financial Reporting Council announced on 17 March a review of the impact of the Combined Code on Corporate Governance, which sets out best practice corporate governance standards for UK listed companies.

Speaking at the Institute of Chartered Secretaries and Administrators' (ICSA) Corporate Governance Conference Sir Christopher Hogg, Chairman of the Financial Reporting Council, said:

Contact us: **0844 561 8166**

In Depth (cont'd)

'While there is no assumption that the Code is fundamentally flawed or that a different regulatory framework for corporate governance could have alleviated the financial crisis, we are clear that the time is now ripe for testing the Code's content and application against the fresh thinking that the crisis must provoke.

'The FRC will liaise closely with Sir David Walker's review of the governance of banks and share relevant research and information.'

The FRC is inviting views on any aspect of the Code, but in particular on:

- the composition and effectiveness of the board as a whole;
- the respective roles of the chairman, the executive leadership of the company and the non-executive directors;
- the board's role in relation to risk management;
- the role of the remuneration committee;
- the quality of support and information available to the board and its committees, and
- the content and effectiveness of Section 2 of the Code, which is addressed to institutional shareholders.

The FRC is also seeking views on how the operation of the 'comply or explain' mechanism could be improved. It requires boards to provide investors with the necessary information on which to make that judgement, and a sufficient number of investors to engage constructively with the companies in which they invest through dialogue and the use of their voting and other rights.

Views are sought from listed companies, directors, investors and other interested parties by 29 May 2009.

The FRC will publish its findings before the end of 2009. If any changes are proposed to the Combined Code or the way in which it operates they will be subject to further consultation.

Copies of the consultation paper and the Combined Code can be found at *www.frc.org.uk/corporate/reviewCombined.cfm*. Responses to the consultation paper are requested by 29 May 2009 and should be sent to: *codereview@frc.org.uk*.

Director/manager share dealings – Model Code amended

The Financial Services Authority (FSA) on 6 March amended the Model Code in its Listing Rules to allow greater opportunities for directors and employee share plans to acquire shares in their company in otherwise prohibited periods. The FSA's Trading Plans Instrument 2009 amends the Model Code, which is located in Ch.9 Annex 1 to the Listing Rules. The Model Code imposes further restrictions on dealing in the securities of a listed company beyond those imposed by statute so as to ensure that 'persons discharging managerial responsibilities' (PDMRs) do not abuse, and do not place themselves under suspicion of abusing, inside information that they may be thought to have, especially in periods leading up to an announcement of the company's results.

The amended Model Code enables PDMRs in listed companies to make arrangements for shares in their company to be bought or sold on their behalf during a prohibited period by an independent third party ('a trading plan').

FINANCIAL REPORTING

EU proposals for abolishing financial reporting obligations for micro-enterprises

The European Commission put forward a new proposal on 29 February enabling Member States – as an option – to completely abolish financial reporting obligations for the EU's smallest companies. Driven in part by the degenerating economic conditions, the new rules are designed to alleviate the regulatory burden on micro-entities.

Micro entities are defined as those companies that on their balance sheet dates do not

Access subscriptions and services online at: **www.cch.co.uk**

In Depth (cont'd)

exceed the limits of two of the three following criteria: balance sheet total of €500.000, net turnover of €1.000.000 and an average number of employees during the financial year of 10. Some 91 per cent of all SMEs fall into the category of micro-entities in the EU.

The aggregate administrative burden reduction potential is estimated by the EC at around €6.3 billion. The proposal, which was flagged in the European Economic Recovery Plan in November 2008, now passes to the European Parliament and the Council of Ministers for consideration in April. However, there are strong feelings about any revision and doubts as to whether it is really helpful to micro companies to abolish as distinct from simplifying accounts.

After a public consultation and the results of a High Level Group of Independent Stakeholders on Administrative Burdens, who supported the idea of allowing the Member States to exempt micro-entities from EU-level financial reporting rules, the Commission delivered this proposal in a short time period.

The Commission stated that 'Micro-entities are mostly engaged in business at local or regional level with no or limited cross-border activity. At the same time, micro-entities are often subject to the same reporting rules as larger companies. This creates a disproportionate burden on these companies. They have a key role in creating new jobs and economic activities but they also have limited resources to comply with demanding regulatory requirements'.

The Commission now intends to launch a stakeholder consultation on the remaining parts of the EU accounting rules in a drive to identify further areas for simplification, in the context of a review of the Fourth and Seventh Council Directives (83/349/EEC on consolidated accounts).

These initiatives are an integral part of the European Commission's Better Regulation strategy aimed at reducing overall administrative costs by 25 per cent by 2012.

APB to replace auditing standards

The Auditing Practices Board (APB) on 2 March announced that it is to update its auditing standards for the new, clarified, International Standards on Auditing (ISAs) issued by the International Auditing and Assurance Standards Board (IAASB) to apply for audits of financial statements for periods ending on or after 15 December 2010.

Since 2004 the APB has aimed to base UK and Irish auditing standards on ISAs. The IAASB has recently completed its 'clarity' project to update and reformat ISAs with the intention that all ISAs redrafted in the clarity format should come into effect internationally on the same date: for audits of financial statements for periods beginning on or after 15 December 2009.

As the improvements that have been made are designed to improve audit quality and the clarity project has been undertaken primarily to improve the intelligibility of the ISAs, the APB believes that it is appropriate to introduce these new standards in the UK and Ireland as soon as is practicable. Responses to an APB consultation paper on adapting ISAs demonstrated very strong support for updating the domestic ISAs (UK and Ireland) to adopt the new clarified ISAs as soon as practicable having regard to the date set by the IAASB and that the same standards should apply to all audits. The IAASB is expected to publish all the finalised ISAs imminently and the APB plans before the end of April 2009 to issue an exposure draft of a complete set of proposed new domestic ISAs (UK and Ireland) with a three-month consultation period with the intention of finalising these by autumn 2009.

The new ISAs include three standards relating to auditor's reports: ISA 700, *Forming an Opinion and Reporting on Financial Statements*, ISA 705, *Modifications to the Opinion in the Independent Auditor's Report* and ISA 706, *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*. Although the

Contact us: **0844 561 8166**

In Depth (cont'd)

APB will be adopting new ISA 705 and ISA 706 it will not be adopting the new ISA 700 but will instead issue a revision of its own ISA (UK and Ireland) 700 that takes account of the conclusions reached and which will not preclude the auditor from being able to assert compliance with the ISAs issued by the IAASB.

FRC publishes going concern update for small company directors

The Financial Reporting Council (FRC) on 3 March issued a short update to help directors of smaller companies on assessing going concern.

The Financial Reporting Standard for Smaller Entities (FRSSE) requires small companies to assess whether the use of the going concern basis of accounting is appropriate and to make disclosures of any material uncertainties. Whilst the full financial statements are not required to be filed at Companies House, they may be given to customers, banks and other lenders to allow business to continue. Copies of An Update for Directors that Adopt the Financial Reporting Standard for Smaller Entities (FRSSE): Going Concern and Financial Reporting are available on the FRC website at *www.frc.org.uk/*.

ETHICAL STANDARDS FOR AUDITORS

APB consults on ethical standards for auditors

The APB on 9 March announced that it had updated its Ethical Standards for Auditors. When revising its ethical standards in 2008, the APB identified a small number of issues where further work and dialogue was needed. That work has been undertaken and the APB is now consulting on further proposed amendments to implement the changes.

The changes relate to topics including:

-
- remuneration and evaluation policies for key partners involved in the audits;
- the provision of non-audit services relating to securitisation and restructuring service;
- the provision of direct assistance to the audit team by internal auditors, and
- the definition of an audited entity's affiliate.

Copies of Consultation Paper: Revised Draft Ethical Standards for Auditors may be downloaded from the APB's website at *www.frc.org.uk/apb/publications/pub1885.html*

COMPANY LAW

DBERR consults on regulations for acquisition of companies' own shares

The Department for Business, Enterprise and Regulatory Reform (DBERR) on 17 March published for comment draft Companies (Share Capital and Acquisition by Company of its Own Shares) Regulations 2009.

The draft regulations, if implemented, would amend provisions in Pt. 17 (a company's share capital) and Pt 18 (acquisition by a limited company of its own shares) of the *Companies Act* 2006. Amongst other things the regulations would:

- reduce the minimum pre-emption rights issue subscription period in s. 562(5) of the 2006 Act from 21 days to 14 days;
- introduce a new requirement in s. 646 (creditors entitled to object to reduction) so that, when creditors object to a reduction in a company's capital, they should demonstrate that their claim is at risk and that the company has not provided adequate safeguards, and
- remove the 10 per cent cap on companies holding shares in treasury and extend the period for which authorisation may be given for the purchase of shares from 18 months to five years.

A copy of the draft regulations is available on the DBERR website *www.berr.gov.uk/files/file50486.pdf*.

Access subscriptions and services online at: **www.cch.co.uk**

In Depth (cont'd)

BANKING REGULATION

The FSA publishes The Turner Review: a wide-ranging review of global banking regulation

The Financial Services Authority (FSA) on 18 March published the Turner Review of global banking regulation. Lord Turner, chairman of the FSA, was asked by the Chancellor of the Exchequer to review the events that led to the financial crisis and to recommend reforms.

The Review identifies three underlying causes of the crisis – macro-economic imbalances, financial innovation of little social value and important deficiencies in key bank capital and liquidity regulations. These were underpinned by an exaggerated faith in rational and self-correcting markets.

It stresses the importance of regulation and supervision being based on a system-wide 'macro-prudential' approach rather than focusing solely on specific firms. It recommends:

- fundamental changes to bank capital and liquidity regulations and to bank published accounts;
- more and higher quality bank capital, with several times as much capital required to support risky trading activity;
- counter-cyclical capital buffers, building up in good economic times so that they can be drawn on in downturns, and reflected in published account estimates of future potential losses;
- a central role for much tighter regulation of liquidity;
- regulation of 'shadow banking' activities on the basis of economic substance not legal form: increased reporting requirements for unregulated financial institutions such as hedge funds, and regulator powers to extend capital regulation;
- regulation of Credit Rating Agencies to limit conflicts of interest and inappropriate application of rating techniques;
- national and international action to ensure that remuneration policies are designed to discourage excessive risk-taking;
- major changes in the FSA's supervisory approach, building on the existing Supervisory Enhancement Programme (SEP), with a focus on business strategies and system wide risks, rather than internal processes and structures, and
- major reforms in the regulation of the European banking market, combining a new European regulatory authority and increased national powers to constrain risky cross-border activity.

The Turner Review distinguishes between those areas where the FSA has already taken action, those where the FSA can proceed nationally, and those where international agreement needs to be achieved. It also recognises that there may be alternative specific ways to achieve the essential objectives of effective regulation.

In addition the Review highlights areas where it is premature to recommend specific action, but where wide-ranging options need to be debated. These include product regulation in retail (eg mortgage) and wholesale (eg CDS) markets.

Lord Turner said:

'The financial crisis has challenged the intellectual assumptions on which previous regulatory approaches were largely built, and in particular the theory of rational and self-correcting markets. Much financial innovation has proved of little value, and market discipline of individual bank strategies has often proved ineffective.

'A global market economy remains the best means of delivering global prosperity: it requires a global banking system focused on serving the needs of businesses and households, not in taking risks for quick return. Major changes in regulation and in supervisory approach are required to deliver that. The approach has to build on a system-wide

Contact us: **0844 561 8166**

OVERMATTER TEXT - OVERMATTER TEXT

In Depth (cont'd)

perspective: failure to look at the big picture was far more important to the origins of the crisis than any specific failures in supervising individual firms. And it must reflect the reality of a global financial system without a global government; we need both far more intense international cooperation and greater use of national powers.

'The changes recommended are profound, and the banking system of the future will be different from that of the last decade. The world's economy will be better served as a result.'

Lord Turner warns that the transition to higher bank capital will need to be managed carefully. UK banks are now capitalised at a level which will enable them to absorb severe stresses, and the short-term priority is to maintain bank lending to the real economy.

Published alongside the Review is an FSA discussion paper (DP) which sets out more detail on specific policy proposals. As the current crisis arose in the banking, investment banking and 'shadow banking' sectors, most of these proposals focus on these sectors. Possible implications for some other sectors are however identified. The Turner Review can be found on the FSA website. ■

Access subscriptions and services online at: **www.cch.co.uk**

Intentionally blank.