CONSULTATION: UK CORPORATE GOVERNANCE CODE

The Institute of Chartered Accountants in England and Wales (ICAEW) welcomes the opportunity to comment on the consultation on the UK Corporate Governance Code ('the Code') published by the Financial Reporting Council ('FRC') dated 24 May 2023, a copy of which is available from this link.

ICAEW is a world-leading professional body established under a Royal Charter to serve the public interest. In pursuit of its vision of a world of strong economies, ICAEW works with governments, regulators and businesses and it leads, connects, supports and regulates more than 166,000 chartered accountant members in over 146 countries. ICAEW members work in all types of private and public organisations, including public practice firms, and are trained to provide clarity and rigour and apply the highest professional, technical and ethical standards.

This response has been prepared by ICAEW’s Corporate Governance & Stewardship team in consultation with a wide range of ICAEW members, technical committees and external experts.

For questions on this response please contact representations@icaew.com.
Restoring trust in the UK’s corporate reporting, governance and audit regime requires a fully ‘joined-up’ approach to reform. Anything less is unlikely to prevent unexpected corporate failures.

Overarching Comments:

- We thank the FRC on this consultation and its openness to listen and receive feedback from a wide range of stakeholders.

- We support revising the Code as part of the wider objective of restoring trust in audit and corporate governance. However, we are concerned that primary legislation has still not been tabled to provide the FRC with stronger powers in the form of the new Auditing, Reporting and Governance Authority (ARGA). Without this crucial legislative step, there is a significant risk that changes to the Code and associated consultations and reforms will not have the desired impact.

- We concur that the revision of the Code is an important stage in the journey towards improved corporate governance. However, it is not the end point, and it is essential that future reform is underpinned by the findings from rigorous academic research on why major companies can fail unexpectedly and what solutions can be employed to mitigate these governance failures.

- We believe that the government’s aims of making the UK listing regime more attractive and improving trust in audit and corporate governance are not mutually exclusive. However, we also believe that the increase in complexity and cost of compliance the proposed changes are likely to bring, may create the appearance that the two aims are incompatible. We encourage the FRC to carefully consider the feedback it receives for both the consultation and the associated guidance to help it strike the right balance.

- We have concerns that the proposed changes do not include key aspects of the revised G20/OECD Principles of Corporate Governance. In particular, the omission of a section on sustainability is disappointing.

- We believe that in the absence of very clear and high-quality guidance, there is a significant risk that the US Sarbanes Oxley (SOX) template will, by default, be applied in the UK, and will be extended from controls over financial reporting to include operational and compliance controls, with significant resource implications.

- We would have liked to have seen a more joined-up review, involving not only the Code, but also the associated guidance. In the absence of the underlying detail, it is difficult to judge fully the proposed changes on their merits or to evaluate whether the whole Code will have the desired impact or be seen as a missed opportunity.

- We urge the FRC to open the associated guidance to a full public consultation to ensure respondents to the Code consultation have sight of the complete picture and can provide informed feedback accordingly. We have outlined some suggestions and recommendations for associated guidance in this document in anticipation, and welcome opportunities to engage with the FRC on this.

- We believe there would be significant value in a resource hub that helps companies understand their reporting requirements. This would include links to associated guidance documents and the relevant regulatory requirements and standards, such as the International Sustainability Standards Board (ISSB) standards on sustainability reporting, and the relevant guidance on producing an Anti-Fraud Statement or Modern Slavery Act Statement. Until the reporting thresholds are synchronised, such a resource will also help companies understand what applies to them and what does not. We stand ready to work closely with the FRC to develop this important resource.
KEY POINTS

A. ENSURE THE CODE REMAINS GLOBAL BEST PRACTICE...

1. The UK Corporate Governance Code is seen globally as an example of best practice. The principles-based, comply or explain model is central to this, as is its general applicability beyond UK-based, premium listed companies. We support maintaining the principles-based, comply or explain model over a more rules-based approach to corporate governance.

2. For the Code to remain global best practice, it should fully align with the revised G20/OECD Principles of Corporate Governance. The Code does not match the OECD Principles in a number of areas, including:
   a) The Principles include a dedicated new chapter on ‘Sustainability and Resilience’, which provides recommendations to support companies in managing the risks and opportunities of the climate transition and other sustainability challenges, as well as covering the growing role of institutional investors and stewardship.
   b) The Principles explicitly encourage companies to establish ethics and compliance programmes to ensure the integrity of the company’s internal control, accounting and reporting systems.

3. The Code must also remain broadly applicable, not just to UK listed companies or public interest entities (PIEs), but to any UK company that aspires to achieve best practice in corporate governance.

4. There is a confusing array of thresholds based on the nature of a company, such as quoted, traded companies (of which there are two definitions\(^1\)), and public interest entities (PIEs). This creates confusion, and we have heard anecdotally of some companies ‘over-reporting’ to avoid the risk of inadvertently not complying with reporting requirements. We recommend a thorough review of the thresholds to simplify and streamline them and to avoid overly complicating the Code and the associated guidance. This recommendation is outlined in detail in our response to DBT’s Smarter Regulation: Call for Evidence on Non-Financial Reporting\(^2\).

5. We urge the FRC to ensure the Code’s continued general applicability by keeping the text at a high, principles-based level and by avoiding adding prescriptive detail or removing key principles because they are covered elsewhere.

B. ...AND IS AMBITIOUS BUT ACHIEVABLE.

6. There has been a strong decreasing trend in the number of companies claiming full compliance with the Code, as per the FRC’s latest Review of Corporate Reporting dated November 2022: ‘While 58 companies claimed full compliance with the Code in 2020, only 27 companies did so this year\(^3\).’

7. Many of the proposed changes to the Code will not be straightforward to report on and will require substantial additional work and disclosures. This is likely to further reduce compliance with the Code to a point at which full compliance risks no longer being seen as achievable, or even desirable, by a significant percentage of companies.

8. While we are strong supporters of the ‘comply or explain’ model, there is a risk that the proposed changes will mean that complying will be perceived as overly costly, or worse, unachievable. The Code must be ambitious but also achievable for listed companies and remain aspirational for others. Those who choose to explain do so for sound governance reasons, and not because complying is too onerous or costly.

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\(^1\) CA2015 s360C and s474
\(^2\) Smarter Regulation: Call for Evidence Non-Financial Reporting (icaew.com)
\(^3\) Review of Corporate Governance Reporting_2022 (frc.org.uk), p6
9. Publicly listed company reports have increased by 46% in length over the last 5 years, with the average FTSE100 annual report now over 237 pages long*. The proposed changes will lead to substantially longer annual reports. It is important that the need for transparency and disclosure is balanced with the overall effectiveness of companies’ reporting and the ability of investors and other stakeholders to analyse corporate reports.

C. DIRECTOR ACCOUNTABILITY AND THE AUDIT COMMITTEE ARE RIGHTLY CENTRE STAGE IN THE REFORM OF AUDIT AND CORPORATE GOVERNANCE...

10. We welcome greater individual and collective director accountability, which we believe sits at the heart of corporate governance reform.

11. We support directors signing off on the effectiveness of the internal control and risk frameworks. We also welcome directors certifying they have sufficient time to discharge their duties as directors, although we are concerned that this may lead to boilerplate statements.

12. The consultation rightly puts the audit committee at the centre of its reforms to restore trust in UK corporate governance and audit. High quality assurance on all aspects of a company’s reporting is key and the audit committee is well placed to ensure this. In practice, the proposed changes represent a significant extension of responsibility, but one we welcome, if boards retain the ability to organise their own affairs and to set up specialised committees or sub-committees where they see fit to share the workload.

13. The additional responsibilities proposed for audit committees do risk creating a ‘board within a board’, or at least a two-tier system within a board where those on the audit committee will have significantly more responsibility than other non-executive directors. This may have unintended consequences, including discouraging high-quality applicants for membership of audit committees.

14. Audit committees will need to consider how they organise and resource their work to manage the additional workload, including setting up sub-committees and/or ensuring other committees share the workload, leaving the audit committee to oversee assurance.

15. We do not support all of the proposals for additional audit committee responsibilities. For example, we do not believe that audit committees should be responsible for all narrative reporting, but rather that they should be responsible for the assurance of all material reporting. Nor do we believe that audit committees should be the main interface with investors, but rather that they should make themselves available, if investors demand it.

D. …WHICH MUST BE SUPPORTED BY A STRONG CONTROL ENVIRONMENT.

16. The UK in 2023 faces very different problems to those faced by the USA in 2003. Our 2019 publication Internal Controls Effectiveness: Who Needs to Know analyses the different internal controls reporting requirements in the UK and the USA. The SOX regime has been effective in the USA, despite its difficult start, but it has not been as successful in other jurisdictions into which it has been transplanted. We therefore support the FRC’s attempts to emphasise the fact that it is not proposing a UK SOX, or SOX lite.

17. However, we believe there is a significant risk that the SOX template will, by default, be applied in the UK in the absence of very clear and high-quality guidance regarding the nature and extent of work required to support the required directors’ statement on the effectiveness of controls. It will also be extended from controls over financial reporting, to include operational and compliance controls, which will have significant resource implications.

18. If the FRC adopts a big-bang approach and does not permit companies to stagger the implementation of reporting on financial, operational and compliance controls, there is also a

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27. As per the OECD Principles, the company’s directors, individually and collectively, should apply high ethical standards and set the right tone from the top to support the code of ethics. This could include supporting statements in the annual report and setting remuneration policies that encourage the right behaviour, and do not inadvertently encourage unethical
behaviour. There should also be consequences for breaches of the code of ethics at all levels of the organisation.

F. UNDERSTANDING DISORDERLY CORPORATE FAILURE IS KEY TO SUCCESSFUL REFORM

28. While the revisions to the Code constitute an important step towards stronger corporate governance, it is not the end destination. We still do not believe there has been sufficient investigation into the causes of unexpected failure and potential solutions.

29. For this reason, ICAEW has initiated a research project, funded by our charitable trusts, to examine the question ‘Why do Companies Fail?’ with a specific focus on the role of internal control and corporate governance in mitigating unexpected failures. We have held a call for literature reviews that explore the mechanisms, both internal (eg, board, audit committee) and external (regulators, market dynamics, social influences), which contribute to averting failures and marking governance success. We believe that academic research has a crucial role in providing evidence for future solutions.

30. From the submissions received, we believe academic research can help to advance understanding of why major companies can fail unexpectedly. We will share our findings with the FRC in due course and encourage the FRC to work closely with ICAEW and other partners to explore further collaboration as the revised Code is implemented.

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5 See ICAEW Thought Leadership: Internal controls reporting: sketching out the options
6 See ICAEW Thoughts Leadership: Marking governance out of 10
FEEDBACK BY SECTION

Our responses should be read in conjunction with the Key Points outlined above.

SECTION 1: BOARD LEADERSHIP AND COMPANY PURPOSE

Q1: Do you agree that the changes to Principle D in Section 1 of the Code will deliver more outcomes-based reporting?

31. In principle, we support the vision to have more outcomes-based reporting on areas of the Code where the company has chosen to explain rather than comply. However, it is worth noting that not every governance action has a separately identifiable outcome, so we caution against being too prescriptive in this regard.

Q2: Do you think the board should report on the company’s climate ambitions and transition planning, in the context of its strategy, as well as the surrounding governance?

32. We believe that the focus on climate and transition planning is too narrow. We support the reporting of broader sustainability considerations in the delivery of the company’s strategy, including its climate ambitions and transition planning where it is material.

33. There is a broader question around sustainability that needs to be addressed. We encourage the FRC to align this aim with the new ‘Sustainability and resilience’ chapter in the revised G20/OECD Principles of Corporate Governance. The OECD Principles give specific examples for application and practicable frameworks and advice for integrating sustainability measures and thinking throughout corporate structures. References to these, or similar, might be helpful to include in the guidance for UK businesses.

Q3: Do you have any comments on the other changes proposed to Section 1?

Comments on the text:

34. It is widely acknowledged that culture, while critical, is difficult to monitor and report on meaningfully. In the absence of detail, we are concerned that the request for Boards to ‘assess and monitor culture and report on how effectively the desired culture has been embedded’, will not lead to insightful reporting but rather boilerplate statements. See our comments below on what we recommend for the guidance.

35. It is also not clear why Principle E ‘The workforce should be able to raise any matters of concern’ has been removed as the associated Provision 6 remains.

What we would like to see in the supporting guidance:

36. To avoid boilerplate statements on culture, the guidance should provide more clarity on what good reporting could look like. Key elements underpinning what is meant by a desired culture could be outlined.

37. Internal controls and risk management frameworks are likely to be ineffective if not underpinned by a corporate culture that encourages employees to do the right thing. This would include complying with the company’s code of ethics, policies, internal controls and all applicable laws and regulations (including those relating to human rights, the environment, fraud and money laundering) and be able to raise concerns without fear of retaliation, including loss of employment or opportunities for promotion, when they notice something amiss. We recommend that the guidance encourages companies to report on these aspects, including encouraging a publicly stated code of ethics.

38. We also recommend that the guidance encourages companies to implement an ethics and compliance programme that underpins the code of ethics, and which also supports the company’s explicit anti-bribery and corruption and anti-fraud policies as well as its compliance with all applicable laws and regulations. Such a programme, if set up correctly and adequately resourced, provides valuable early warning signals that if left unchecked
could lead to corporate failure. This would also bring the Code into alignment with the revised G20/OECD Principles of Corporate Governance (section V.D.8) which encourages the setting up of ethics and compliance programmes.

39. The company’s directors individually and collectively should apply high ethical standards as per the OECD Principles and set the right tone from the top to support the code of ethics. This could include supporting statements in the annual report and setting remuneration policies that encourage the right behaviour and do not inadvertently encourage unethical behaviour. They should also ensure that staff can raise concerns without fear of reprisal and that there are consequences for breaches of the code of ethics at all levels of the organisation.

40. The audit committee or another committee made up of non-executive directors should have oversight of the Ethics and Compliance Programme, including the Speak Up/whistleblowing line. The relevant committee should request regular updates which include concerns and remedies in relation to breaches of the code of ethics and the Ethics and Compliance Programme. The Chair of the Board and that of the relevant committee should provide unfettered access to head of the programme.

41. In the underlying guidance to Provision 6, we would like to see stronger language that aligns with good practice in the area of whistleblowing, for example the Government’s ‘Guidance for Employers and Code of Practice’ on whistleblowing. We would like to see explicit language on the role of the board and their role in encouraging a ‘Speak Up culture’ and ensuring that those who speak up do not suffer retaliation. We also encourage the company to make such channels available to other business partners such as onsite freelance staff, subcontractors, and other suppliers.

SECTION 2: DIVISION OF RESPONSIBILITIES

Q5: Do you agree with the proposed change to Code Provision 15, which is designed to encourage greater transparency on directors’ commitments to other organisations?

42. Feedback from members, industry, investors and other professional bodies indicates that this is not a significant issue in the UK. The current proposals on getting directors to make declarations will most likely lead to boilerplate statements.

SECTION 3: COMPOSITION, SUCCESSION AND EVALUATION

Diversity and Inclusion

Q6: Do you consider that the proposals outlined effectively strengthen and support existing regulations in this area, without introducing duplication?

43. Although it may be desirable to avoid duplication, where there is a clear regulatory requirement in relation to diversity, the principles underpinning this legislation could be mentioned without causing duplication. The associated guidance can further help ensure harmonisation of targets and ambition in this regard by highlighting the standards set by other relevant bodies.

Q7: Do you support the changes to Principle I moving away from a list of diversity characteristics to the proposed approach which aims to capture wider characteristics of diversity?

44. We support stronger diversity language and moving beyond gender and ethnicity. However, the language of protected and non-protected characteristics seems out of place here. We urge the use of plain English to describe what the Government’s and the FRC’s ambition is in this regard.
Q8: Do you support the changes to Provision 24 and do they offer a transparent approach to reporting on succession planning and senior appointments?

45. Overall, we are supportive. However, we are not convinced that it is for the nominations committee to report on effectiveness of the company’s diversity and inclusion policy, but rather to report on the outcomes of the company’s efforts to increase diversity and inclusion.

46. We believe Provision 24 should not only focus on gender diversity of those in senior management and their direct reports but should also encourage other aspects of diversity as outlined in Principle 1 for board members.

What we would like to see in the associated guidance:

47. We welcome more detail on what is expected in terms of how to report on diversity metrics. We would also like the associated guidance to link to the relevant reviews such as the Parker Review.

48. We strongly encourage joined-up thinking with other regulatory bodies in this area. The FCA have set hard targets in relation to specific areas of diversity on boards and although we appreciate it is not for the Code to set these, referencing good practice and expectations in the guidance will help ensure a level playing field across sectors and industries.

Board Performance Reviews

Q9: Do you support the proposed adoption of the CGI recommendations as set out above, and are there particular areas you would like to see covered in guidance in addition to those set out by CGI?

49. We support changing the focus from board evaluations to board performance reviews and are also largely supportive of the recommendation of the CGI in relation to improving guidance.

50. However, we do not think it realistic to expect boards to list adverse findings or list detail relating to the performance reviews of individual directors.

SECTION 4: AUDIT, RISK AND INTERNAL CONTROL

General feedback on section 4

51. Making the UK attractive as a place to do business and raising standards of audit and corporate governance at the same time, is a challenge in the short term. Ultimately though, these goals converge, and we support the FRC’s objectives of raising standards relating to internal controls in a manner that is proportionate and right for the UK.

52. As outlined in the Key Points section of our consultation response, the UK in 2023 faces very different problems to those faced by the USA in 2003 and we therefore support the FRC’s attempts to emphasise the fact that it is not proposing a UK SOX, or SOX lite.

53. Without very clear guidance there a significant risk that the SOX template will, by default, be applied in the UK. Additionally, if the FRC adopts a big-bang approach and does not permit companies to stagger the implementation of reporting, there is also a risk that the scale of the task of implementing the proposed requirements will lead to either limited value shallow reporting, or a high level of explanations of non-compliance, A balance therefore needs to be struck and the FRC needs to acknowledge that real change will come at a cost.

54. It will take time for companies to develop non-financial controls and for a ‘controls’ mindset to develop into a more holistic ‘risk management’ mindset. The early years of reporting may involve more explanation than compliance in these areas and there needs to be greater emphasis on the need for companies to follow issues through over multiple reporting periods, explaining changes along the way. For the regime not to default to SOX, the FRC needs to clearly circumscribe the nature and extent of work it expects of companies in its guidance and consider transitional arrangements for smaller companies.
55. Forcing companies to report before they have had the chance to implement the required changes properly will risk the intended improvements to corporate governance sought through the enhanced Code.

Audit and Assurance Policy (AAP)

**Q10: Do you agree that all Code companies should prepare an Audit and Assurance Policy, on a 'comply or explain' basis?**

56. We agree that all Code companies should prepare an Audit and Assurance Policy, on a comply or explain basis. However, in ICAEW's Audit and Assurance Faculty's publication, *Developing a meaningful Audit and Assurance Policy*, updated in 2023, we urged companies of all sizes - not just Code companies or those meeting the UK government’s new sized-based criteria - to seize the moment to create a policy, rather than waiting for this to become mandatory.

57. A broader range of companies providing information voluntarily would bring greater transparency and clarity on a wide range of issues and be of potential value for all users of the financial statements. This would also provide clarity to regulators and support them in fulfilling their supervisory role.

58. A growing number of companies are starting to develop such policies and a number have been published. They vary in terms of length and quality and companies will actively seek examples and guidance in an attempt to calibrate their own disclosures. Others have simply stated in their annual reports that a policy is being developed and that they will be looking to the FRC for practical guidance. ICAEW has provided detailed commentary to DBT at several stages of the development of secondary legislation and stands ready to assist the FRC and DBT with the development of guidance. ICAEW's Audit and Assurance Faculty is considering the development of further practical guidance.

59. The FRC needs to give further consideration to the distinction between internal audit, external audit, and other external assurance providers. In our report, we encourage a cohesive and complete narrative covering all sources of audit and assurance to indicate where and how directors obtain their comfort. Companies we spoke to in developing our report were keen to seek assurance from a range of providers, to optimise the use of external specialist skills and internal expertise. They are considering a wider range of risks, the nature of assurance demanded, and who might provide it.

60. In our publication we also encourage companies to put in place an internal audit function as this provides the essential ‘3rd line of defence’ for the executive and boards in relation to audit, assurance, risk and internal controls. The function should be independent with a primary reporting line to the chair of the audit committee. We recommend that the guidance continues to outline good practice in this regard and explicitly recommends an internal audit function and where companies do not have one, they should explain how the audit committee is obtaining this independent internal perspective.

61. In our report, we also encouraged audit committees to ‘own’ the policy on behalf of the board. However, we question the proposal that the audit committee leads engagement with shareholders and other stakeholders in this area. Our members who serve on audit committees tell us that they have full agendas, and that there is often little demand from investors for engagement. With the additional responsibilities proposed, we are also not convinced that audit committees have the bandwidth to act as the main or significant link between the board and investors. We believe there are others better placed to lead this, including the board chair and the executive. The Code itself requires boards to ensure there is effective engagement with stakeholders. Audit committee chairs should continue to make themselves available to investors and stakeholders on an as needs basis.

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What we would like to see in the associated guidance

62. Guidance must be sufficiently granular to be useful and should be provided by the FRC before commencement of the regime.

63. There will now be a number of audit firms auditing Code companies for the first time, and guidance should therefore target auditors as well as preparers.

64. Guidance for how the boards can engage with stakeholders will be welcome, especially as companies will be required to explain how they have taken account of shareholder views as well as whether they have taken account of employee views. In ICAEW’s Audit and Assurance Faculty’s 2019 report, User-driven assurance: fresh thinking, we outline principles for companies to consider when attempting to engage investors and others in developing the assurance process.

Audit committees and the External Audit: Minimum Standard

Q11: Do you agree that amending Provisions 25 and 26 and referring Code companies to the Minimum Standard for Audit Committees is an effective way of removing duplication?

65. Although amending Provisions 25 and 26 and referring Code companies to the Minimum Standard for Audit Committees is an effective way of removing duplication, we have concerns that the Standard and the Code may diverge in term of their applicability. Removing references in the Code may result in the Code applying to some companies, to which the Standard does not, leaving the latter with no reporting obligations in this regard, which may not be the intended outcome. We recommend that the key principles are retained.

Sustainability Reporting

Q12: Do you agree that the remit of audit committees should be expanded to include narrative reporting, including sustainability reporting, and where appropriate ESG metrics, where such matters are not reserved for the board?

66. The increasing overlap between financial and non-financial reporting means that it is sensible for narrative reporting to be considered by the audit committee. We believe that the audit committee’s remit should cover assurance relating to all material reporting, financial and non-financial, and that this should include sustainability reporting and ESG metrics. The audit committee should also have oversight over the processes that produce such reports and metrics.

67. Many companies will need to reassess the make-up of the skills and competencies on their audit committee to take into account sustainability reporting, ESG metrics and wider narrative reporting.

68. Although there is currently a significant focus on environmental reporting, the language in the Code should be such that it is sufficiently future-proofed to encourage other aspects of sustainability reporting such as stakeholder relationships and social reporting. We would encourage the FRC to align with the Sustainability chapter in the revised G20/ OECD Principles for Corporate Governance in this regard.

69. While ICAEW believes assurance standards such as ISSA 5000, currently being exposed, should be profession-agnostic, there will be occasions when the statutory auditor is best placed to deliver high quality assurance because of their knowledge of the client, familiarity with challenging estimates and quality management standards, and because of the requirements for them to comply with robust ethical standards. However, the 70% non-audit services fee cap, in its current form, may prohibit auditors from delivering this work. We urge the FRC to engage with DBT and other relevant stakeholders to discuss the fee cap, including how emerging assurance activities might impact it. A non-assurance fee cap might be considered.

8 User-driven assurance: fresh thinking | ICAEW
70. We also believe that delivering sustainability assurance provides the statutory auditor with a better understanding of the sustainability risks and opportunities faced by the business and that there could be a positive impact on the quality of statutory audits as a result.

71. We suggest that the FRC include detailed practical steps that businesses can take on these aspects of sustainability reporting in the accompanying guidance to the Code. For such a new and fast evolving area as reporting on climate ambitions and transition planning, it is important for businesses to have practical guidance as to what is expected of them. We would also encourage the FRC to align with the Sustainability chapter in the revised G20/OECD Principles for Corporate Governance in the guidance. Robust and practical guidance is key to the successful implementation of the provisions being introduced in this Code.

Risk Management and Internal Controls

Q13: Do you agree that the proposed amendments to the Code strike the right balance in terms of strengthening risk management and internal controls systems in a proportionate way?

72. We agree that the proposed amendments to the Code have the capacity to strengthen risk management and internal controls. However, the FRC should consider a proportionate and scalable approach and encourage companies and their advisors to decide for themselves how best to report on their internal control and risk frameworks.

73. The FRC’s proposed approach, requiring operational and compliance controls to be included from the outset, risks replicating the costly mistakes made in the early days of SOX, and exacerbating them because of the many additional controls covered.

74. Alternatively, in a rushed attempt to meet the deadlines, companies may simply scope material weaknesses and the controls to be covered so narrowly, and at such a high level, there will be no substantive changes to controls and no useful reporting. Both outcomes would indicate a missed opportunity for audit reform.

75. The SOX regime has been in place for 20 years and the new proposed UK regime is a great deal wider than US SOX, as well as less rigorous. The outcomes will not be the same and the FRC needs to manage the expectations of all stakeholders in this respect.

76. The provision of high quality, sufficiently granular supporting guidance on a timely basis is likely to be critical to the perceived and actual success of the new regime in the UK.

77. Otherwise boilerplate explanations for non-compliance risks becoming the norm, which would be a highly undesirable outcome.

78. The guidance underpinning the proposals will to a great extent determine the quality of outcomes, particularly in the new, highly subjective and as yet untested areas of:
   a) materiality of control failures (all areas).
   b) operational and compliance controls, and risk management more widely.

79. Regulatory tolerance of inconsistencies across and within industries, reflecting vastly different risk appetites, over an extended period will be needed if widespread boilerplating, is to be avoided.

80. The cost of compliance with the internal controls reporting requirements is significant, as is the risk of non-compliance, or superficial compliance. For these reasons, staggered implementation for reporting on operational and compliance controls, particularly for smaller companies, must be considered real and proportionate change is to take place.

81. US academic evidence suggests that while the disclosure of control weaknesses or deficiencies enhances earnings credibility, the equity markets react negatively. Companies making such disclosures suffer higher audit fees, modified and/or delayed audit reports, higher debt costs and lower credit ratings.
Q14: Should the board's declaration be based on continuous monitoring throughout the reporting period up to the date of the annual report, or should it be based on the date of the balance sheet?

82. To be consistent with PCAOB requirements, the board's declaration should be at the balance sheet date. This avoids the need to disclose weaknesses that have been remedied which, although of interest, is likely to draw attention from more serious matters, and in practice requires monitoring of controls during the period in any case. If the declaration is to cover the entire period, it should be based on 'regular' monitoring (rather than 'continuous') and it is important that guidance clarifies a de minimis limit for what constitutes 'regular'. Monitoring on a quarterly basis will be a significant step up for some companies, and wholly inadequate for others, depending on their risk profile and risk appetite.

Q15: Where controls are referenced in the Code, should 'financial' be changed to 'reporting' to capture controls on narrative as well as financial reporting, or should reporting be limited to controls over financial reporting?

83. We think that this change will exclude financial controls that are not financial reporting controls and therefore we suggest adding reporting to the list of controls rather than replacing 'financial' with 'reporting'.

Q16: To what extent should the guidance set out examples of methodologies or frameworks for the review of the effectiveness of risk management and internal controls systems?

84. The absence of guidance providing frameworks for the review of the effectiveness of risk management and internal controls systems will render the regime ineffective and costly, replicating the mistakes made in the early years of SOX. For the introduction of the regime on a 'big bang' basis, as proposed by the FRC, sufficiently detailed and granular guidance on the framework for reporting on financial, operational and compliance controls is critical from the outset. Leaving the development of such frameworks to companies will make it very difficult for investors to make meaningful comparisons.

85. Implementing the proposals in a proportionate way requires a staggered approach to reporting on controls if improvements to risk management and internal controls are to be made. As we noted in Rep 63/21:

"...preparers and many auditors are clear that the only practical way forward for a new UK regime is to focus on Internal Controls over Financial Reporting (ICFR), at least initially. But more work is needed to clarify what this means within guidance, which must cover the extent to which Tech controls are in scope."

86. Rep 63/21 noted that a UK regime must:

"...comprise high-quality testing and evaluation of controls, a UK-specific reporting framework, and proper, phased implementation to get it right first time."

87. That response also noted a skills and experience gap in the US market until companies and auditors were able to educate themselves on the SOX regime. Current staff shortages in the audit market, and similar staff shortages in the corporate sector, particularly for smaller companies and particularly in IT, make this an even bigger challenge in the UK now than it was in the USA two decades ago. It is a compelling reason to reconsider the proposed 'big bang' approach, and to bring operational and compliance controls into the regime some 2-3 years after commencement of reporting on controls over financial reporting.
Q17: Do you have any proposals regarding the definitional issues, eg, what constitutes an effective risk management and internal controls system or a material weakness?

88. We noted in Rep 63/21 that the definition of deficiencies, and material weaknesses is critically important. Those definitions are dependent on the definition of an effective system. We agree that in the absence of a mandatory external assurance requirement, it will be necessarily for the company to determine which weaknesses are material, but without generally accepted definitions, there will be no consistency and no comparability.

89. The FRC states that its proposed working definition of material weakness9 is in line with the definitions of the PCAOB, COSO and ISAs UK. The PCAOB and/or US firms may take a different view of the alignment with PCAOB standards, especially given the much wider scope of the proposed definition. A deficiency is described as a …shortcoming in the design, implementation or operation of any of the components of the risk management and internal control systems, affecting …any of the company’s strategic, operational, reporting or compliance objectives.

90. The principal concerns are the boundaries of the systems in scope. This reinforces the critical importance of the availability of good quality guidance before the regime starts.

Q18: Are there any other areas in relation to risk management and internal controls which you would like to see covered in guidance?

91. Yes. We provide detailed comment on what we would like to see included in the guidance elsewhere in this document.

Going Concern

Q19: Do you agree that current Provision 30, which requires companies to state whether they are adopting a going concern basis of accounting, should be retained to keep this reporting together with reporting on prospects in the next Provision, and to achieve consistency across the Code for all companies (not just PIEs)?

92. We agree that current Provision 30 (companies to state whether they are adopting the going concern basis) should be retained.

93. However, the lack of exact alignment between this provision and the draft legislation means that reporting inconsistencies are likely to arise, exacerbated by the distinction between the mandatory nature of reporting by PIEs and the comply or explain basis of the Code for both PIEs and non-PIEs. This also applies to the Minimum Standard and the AAP. The Code, combined with the draft legislation covering the resilience statement, applies to a very wide range of listed and unlisted PIEs and non-PIEs. We welcome the FRC’s attempts to achieve greater consistency across the Code for all companies, but we are not convinced that it will result in much greater consistency, or indeed quality of reporting on going concern.

Resilience Statement

Q20: Do you agree that all Code companies should continue to report on their future prospects?

94. We agree that all Code companies should continue to report on their future prospects, that applying current provision 31 to PIEs would duplicate the Resilience Statement, and that the provision should no longer apply to these entities. This goes some way to simplifying the re landscape. However, as noted in our response to Q19, above, we believe that the impact of the proposals is likely to be hampered by the tensions between the different regulatory inputs to going concern and resilience. The dangers associated with ‘getting it wrong’ in this area are significant and we are not confident that the boilerplate associated with the viability statement can be avoided in these circumstances. A wider, holistic, root and branch review of the whole area is needed.

9 A fault, deficiency or failure in the design or operation of the risk management and internal control framework, such that there is a reasonable possibility that the company’s ability to identify, assess, respond to or monitor risks to its strategic, operational, reporting and compliance objectives is adversely affected.
Q21: **Do you agree that the proposed revisions to the Code provide sufficient flexibility for non-PIE Code companies to report on their future prospects?**

95. We agree that the proposed revisions are sufficiently flexible for non-PIE Code companies to report on their future prospects. Whether they will choose to do so, and the quality of reporting, are other matters.

SECTION 5: REMUNERATION

Changes to strengthen links to overall corporate performance

**Q22: Do the proposed revisions strengthen the links between remuneration policy and corporate performance?**

96. We support the proposed changes to strengthen links between remuneration policies and the company’s performance. We also support increased transparency in this area and linking remuneration to long-term sustainable success.

97. Although we support remuneration tied to ESG metrics, poorly designed or easily achievable ESG metrics tied to executive pay, will encourage ‘gaming’ by senior executives to meet these targets to increase their pay. Remuneration committees should ensure the metrics used for evaluating performance in this regard are well designed, ambitious and verifiable.

Malus and Clawback

**Q23: Do you agree that the proposed reporting changes around malus and clawback will result in an improvement in transparency?**

98. We note that the remuneration committee letter already outlines significant matters, which would include malus and clawback. This is an infrequent topic to be reported on for most companies so we are unsure what else would be expected to be reported on. Our concern is that requiring annual disclosures will just add boilerplate to already overlong reports. We suggest that outlining what is expected is a matter for the guidance.

Changes to Improve the Quality of Reporting

**Q24: Do you agree with the proposed changes to Provisions 40 and 41?**

99. We would only support the removal of provision 40, which outlines the factors that remuneration committees should consider when determining executive director remuneration and practices from the Code, if they are destined for the guidance.

**Q25: Should the reference to pay gaps and pay ratios be removed, or strengthened?**

100. We believe that references to pay gaps and pay ratios should be strengthened rather than removed. Pay reporting is becoming increasingly common practice across sectors and industries and is a good way for a company to attract and retain talent and investors. The detail around how to report would likely be better suited to the guidance than the main body of the Code itself.