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6 September 2023

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Dear David,

EY UK's response to the consultation on revisions to the UK Corporate Governance Code

We welcome the opportunity to comment on your proposals to revise the UK Corporate Governance Code (the Code). The consultation forms an important step in progressing the Government's audit and corporate governance reforms.

We recognise that the Government and the FRC have a delicate balancing act - on the one hand, increasing the attractiveness of the UK as a listing destination and a place to do business and on the other, enhancing trust in the strength and quality of the UK capital markets through high governance and reporting standards. Therefore, it is important that the implementation of the reform measures, including the proposed changes to the Code, strikes the right balance between these two objectives.

To support the debate on these important revisions and encourage others in the ecosystem to respond, we published EY UK's points of view (PoV) on key aspects of the proposals in mid-August, ahead of your response deadline. This letter must be read in conjunction with our PoV as we have not replicated the detail from our PoV (enclosed), but instead focussed on high-level, overarching comments.

Overall comments

1. Regulation must be proportionate and focussed given improved trust in business
   The Government's policy objective with the reforms was to restore trust in business. It is notable from the latest Edelman Trust Barometer[1] that in the UK, business is now the only institution seen as competent and ethical and there have been sustained and successive rises in trust in business over the last few years. While more can undoubtedly be done to improve trust in business (as well as other institutions), it is important that this change of sentiment over the last few years is recognised, and the proposals are therefore proportionate, clear and appropriately balance benefit and cost. This is also important in the context of growing expectations on business to do more for example, in alleviating inequality and the cost of living crisis.

   With this in mind, and as further elaborated in our PoV, it is important that the Code:

   - does not duplicate other legal or regulatory requirements or create unhelpful nuances with such requirements;
   - is not unnecessarily prescriptive such that increasing numbers of companies chose to use explanations and see these as a "get out of jail card" thereby diluting the spirit of comply or explain, but where needed and especially in areas of significant change, it provides clarity; and
   - retains its international stature and thereby doesn't incorporate UK legislative elements.

   Our PoV sets out our concerns about potential negative consequences of these objectives not being achieved.

[1] 2023 Edelman Trust Barometer, UK Supplement Report

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2. Changes in relation to risk management and internal controls (RM and IC)

Given this is the area of change that has received most attention, we feel it is important to emphasise our views here.

We support the notion of a flexible, principles-based governance Code as noted above. Changes to RM and IC are however an area where companies require granularity and direction. In our response to the Government's 2021 consultation, we therefore advocated for the changes in relation to RM and IC to be introduced on a legislative footing. In light of the Government's policy decision not to do so, we support the FRC's proposals on RM and IC to make clearer the board's accountability and to enhance transparency by providing a stronger basis for reporting on and evidencing the effectiveness of the RM and IC framework. However, in order for these to have the intended impact, the following are required:

a. A regulator with powers to hold directors to account

The ability to hold directors to account for their declaration is critical. We therefore continue to call for the formation of ARGA with the appropriate statutory powers to do this.

Without enhanced director accountability, we remain concerned that the FRC's proposed changes (including the directors' declaration) may been by some companies simply as reporting changes, rather than spurring companies with less mature/effective RM and IC systems to improve them.

b. The FRC's guidance must clarify the framework and a minimum baseline of processes/activities that must be undertaken to make a declaration

In light of the fact that the changes are being introduced on a non-legislative basis, the FRC must provide via clear guidance, a framework and a minimum baseline of processes/activities that must be undertaken to make a declaration.

Ambiguity caused by a lack of clarity about what is required of directors, will create several risks:

- 'False comfort' being provided by unsubstantiated declarations, especially if mechanisms to hold directors to account for the declaration are not introduced promptly, as noted above.
- A lack of comparability across companies, making it difficult for investors to assess the robustness of companies' declarations.
- Unnecessary cost and effort incurred by companies in trying to determine how much is enough, especially given the broad scope. This could impact on resource and capital allocation and ultimately UK competitiveness and growth.
- Uncertainty on whether external assurance over the declaration can be provided – this is important given the proposed Audit and Assurance Policy (AAP) requires directors to state whether or not independent external assurance will be sought over internal controls over financial reporting (ICFR). Unless there is clarity, there will be a risk of the audit expectation gap widening further and contributing to the 'false comfort'. We are also of the view that it should not come down to the audit or assurance profession having to determine what this minimum baseline should be to be able to provide assurance. This may happen inadvertently, absent a clear framework and guidance from the FRC.

Therefore, the FRC's forthcoming guidance on RM and IC is critical. Ideally it should have been made available simultaneously with the draft revised Code but in absence of this, we feel it is important for stakeholders to have the opportunity to review and comment on it before it is finalised.

### 3. Timing

We recognise that there is a fine balance between allowing companies sufficient time to prepare in earnest and keeping the momentum especially given it is now nearly five years since the Government embarked on its reform agenda. On balance, we are therefore supportive of a 1 January 2025 implementation date, with the following provisos:

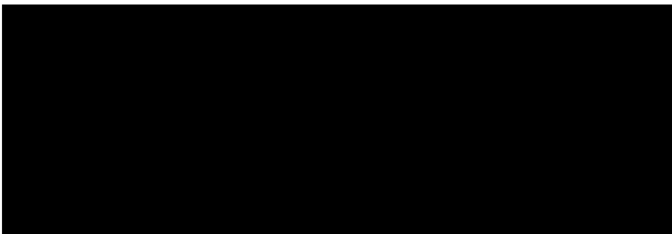
a. The Code and granular supporting guidance must be issued in final form by early December 2023 for the reasons noted in 2b above.

b. There should be a phased implementation of the changes in relation to RM and IC i.e., starting with ICFR. As explained in our PoV, we believe this will:

- be more resource efficient as it will allow companies to carry forward lessons learnt from ICFR into the other areas (such as non-financial reporting). It will also allow the FRC to progressively refine its guidance in areas such as operational and compliance controls to ensure it is meaningful.
- allow companies to embed controls over new non-financial reporting.
- align with the spirit of the AAP which requires a three-year forward look on the evolution of assurance activities.
- avoid further delays that some stakeholders may call for to allow companies adequate time to make a single declaration covering all components of RM and IC.

We hope that together with the detail in our PoV, our observations are useful to the FRC as it finalises the Code and the supporting guidance. We are happy to discuss our views further with you and are also willing to engage over the next few weeks on the supporting guidance.

Yours sincerely



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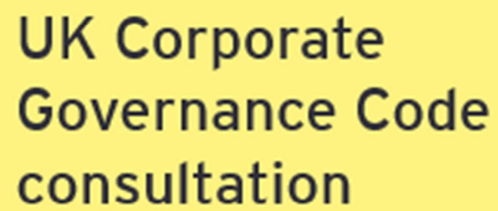
Enc. EY UK points of view on key proposals to revise the UK Corporate Governance Code, August 2023



# UK Corporate Governance Code consultation

## EY UK's points of view on key proposed revisions

**August 2023**

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NOTE: The foreword and the factual overviews of the proposed changes have been deleted from this document, for the purposes of submitting EY UK's response (dated 6 September 2023) to the FRC. No other changes have been made to the original version of this document issued on 15 August 2023.

# 1. Risk management and internal controls

(Relevant consultation questions 13, 14, 15, 16, 17, 18)

Headline points of view

- We support the expansion of the scope of controls to include controls over non-financial reporting.
- We also support the introduction of the directors' declaration; however, we would recommend for its phased implementation or for directors to have the choice to make the declaration by 'component'.
- We advocate for supporting guidance that must clarify expectations on the minimum baseline of what directors need to do make the declaration; clarify definitions that will aid comparability; allow for assurance; and mitigate against the risk of 'false comfort.'
- We advocate that the declaration should be based on control effectiveness as at the balance sheet date and favour the use of the term "regular monitoring" as opposed to "continuous monitoring".

In its response on strengthening the UK's audit, corporate reporting and corporate governance systems published in May 2022, the Government concluded that there are risks in putting a directors' statement on risk management and internal control systems (RM and IC systems) on a legislative footing and asked the FRC to consult on strengthening the internal control provisions in the UK Corporate Governance Code (UK CG Code) instead.

The changes proposed in the consultation seek to implement the Government's policy decision by making clearer the board's accountability for risk management and internal controls (RM and IC) and enhancing transparency by providing a stronger basis for reporting on and evidencing the effectiveness of the framework of RM and IC (covering operational, compliance and reporting controls). The FRC's objective is to make the requirements flexible and proportionate such that companies are able to tailor their arrangements to their own circumstances.

Our overall views on the themes related to this proposal are set out below. Out of all proposals, this one has drawn significant attention. Hence, we have also included our responses to specific questions and a detailed analysis of what we consider should be covered in the underlying guidance (that the FRC will issue in due course) in the Appendix.

We support the expansion of the scope of controls to include controls over non-financial reporting and for directors being required to make a declaration over the effectiveness of RM and IC systems, subject to the following considerations:

1. The FRC's guidance will be critical to determining the extent to which the new measures consistently achieve the desired behaviours from directors

At this point, it is difficult to assess whether the FRC's objectives of:

i) Clarifying the board's accountability for RM and IC systems, and

ii) Enhancing the transparency of reporting in a flexible and proportionate manner

have been achieved, as the guidance which will underpin the basis for the new reporting and which is critical to making this determination, has yet to be developed.

The very nature of the changes being implemented through the UK CG Code and supported by non-binding guidance that the FRC has stated "will not be prescriptive" makes the proposals more flexible and therefore proportionate than a legislative approach. However, the genesis of the audit and corporate governance reforms was to enhance society's trust in the wider UK business environment following corporate scandals and collapses. So, whilst flexibility and proportionality are laudable aims, the proposed approach will result in a lack of comparability across companies, making it difficult for investors to assess the robustness of companies' declarations over the effectiveness of their RM and IC systems.

This could in practice lead to adverse outcomes by creating 'false comfort' as further discussed below, especially if mechanisms to hold the board to account for the declaration are not introduced promptly.

2. The guidance should provide a framework and minimum baseline for compliance to address the risk of 'false comfort'

Whilst accepting that the Code is principles-based, we recommend the guidance that is developed both:

- references a framework against which controls can be mapped, allowing gaps to be identified, and
- has a degree of granularity that provides direction for companies, especially in respect of internal controls over financial reporting (ICFR).

Directors will require some clarity on the minimum baseline of activities/processes that must be undertaken in order to declare that RM and IC systems are effective. Clearly directors can do more, but without this baseline, market practice will vary considerably as some companies take advantage of the flexibility that is being afforded. Far from giving investors clarity on the strength of a company's RM and IC systems, it might lead to 'false comfort' if unsubstantiated declarations are made to tick a reporting box.

Equally, without a baseline, the ambiguity faced by companies trying to determine how much is enough could drive unnecessary cost and effort, which will impact on resource and capital allocation and ultimately UK competitiveness and growth. This was the case in the early days of implementing US SOx, when many projects were over-scoped.

This would be a sub-optimal outcome if repeated in the UK, especially given that UK plcs will potentially be faced with implementing the changes to the Code at or around the same time as a number of other requirements, such as International Sustainability Standards Board (ISSB) Standards, transition plan reporting, and new reporting driven by the Government's secondary legislation.

Absent a framework and baseline, we consider that some companies' Audit and Assurance Policies (AAPs) will use this ambiguity to explain why external assurance over ICFR has not been sought. In fact, without some granularity over the minimum baseline, it is uncertain whether external assurance over the declaration can be provided. Without assurance, the credibility of the declaration will be unclear. Until such a time that this is clarified, there will be a risk of the audit expectation gap widening further and contributing to the 'false comfort'.

It should not come down to the audit or assurance profession to have to determine what this minimum baseline should be. Absent a framework and guidance, this will inadvertently happen if the profession is to be

able to provide assurance. This would be a sub-optimal outcome as the bar may not be set at the appropriate level and will likely differ from one assurance provider to the next.

The Government's response trailed that, as part of a future consultation on the content of audit reports, the FRC will explore whether and how more information about the work auditors have undertaken on the internal controls over financial reporting, could be provided. This would however be limited to observations based on work carried out as part of the statutory audit and would not amount to assurance.

3. A phased approach to implementation or allowing companies to declare by component of RM and IC systems will lead to better outcomes

The key assumption underpinning the proposed approach is that directors will want to be in a position to make a positive public declaration of effectiveness to provide confidence to the market about the robustness of the company's RM and IC systems. The scope of the declaration however is very broad and covers different components of RM and IC systems that will likely have varying degrees of maturity. Most notably, whilst we support the expansion of controls to cover non-financial reporting, in our opinion, these controls will generally be less embedded than those related to areas covered in the current Code.

For many companies, a single declaration covering the effectiveness of operational, compliance and reporting RM and IC systems from the very outset may be a significant undertaking. This could have the unintended consequence of diluting the declaration to the lowest common denominator, especially if companies feel under pressure to be substantially progressed across all aspects by early 2025.

For this reason, we would strongly encourage the FRC to consider a phased approach that involves initially limiting the directors' declaration on effectiveness to address ICFR only, whilst maintaining the current requirements of the 2018 Code, namely, to monitor the entirety of the company's RM and IC systems and, at least annually, carry out a review of their effectiveness and report on that review in the annual report.

This phasing will also:

- allow companies to carry forward lessons learnt from ICFR into the other areas (such as non-financial reporting (NFR)) and could additionally create cost efficiencies.
- align with the spirit of the AAP that provides a three-year forward look on how internal and external assurance activities will be evolving.
- allow companies to embed controls over new reporting (as mentioned above) before having to consider declaring their effectiveness.
- assuage fears that there could be further delays to the effective date (beyond 1 January 2025) to allow companies more time to prepare to make a single declaration covering all components.

If this phasing is not implemented, we suggest that, at the very least, the FRC clarifies in its guidance that the directors' declaration can be tailored to address each component of RM and IC (i.e., risk management, financial reporting, non-financial reporting, operating and compliance) separately.

4. Balance sheet date reporting and "regular monitoring" (rather than continuous) will aid clarity and consistency

To avoid confusion around cut-off and creating inconsistencies with the US SOx regime, we advocate that the declaration should be based on control effectiveness as at the balance sheet date. We acknowledge that the situation is different for risk management and operational and compliance controls. However,

as far as reporting controls over information in the ARA are concerned, material weaknesses that arose during the year but were remediated by the year-end, or those that arose in the post balance sheet period, do not create a risk to year-end reporting. Furthermore, if the declaration has to reference effectiveness 'throughout the period', any material weaknesses identified and remedied during the year will still result in an overall conclusion that controls were not effective.

It is also unclear what extent of continuous monitoring would be required in order to give the directors confidence to make a declaration that controls were effective at every point throughout the period and the cost implications of this for companies. Reasonably defined monitoring (performed at statistical and judgemental intervals rather than on a continuous basis) should therefore be one of the inputs into the basis for allowing directors to make a declaration about effectiveness as at the balance sheet date.

In its November 2022 Review of Corporate Governance Reporting, the FRC emphasised that "Good reporting should include details on how the board monitors these systems on a regular basis, in addition to a formal annual review. In line with this, we would favour the use of "regular monitoring" over "continuous monitoring".

## 2. Interaction with the Government's proposed secondary legislation on reporting measures

(Relevant consultation questions 10, 19, 20, 21)

Headline points of view

- Whilst we consider the AAP to be a meaningful reporting measure, we are not supportive of it being referenced in the Code.
- We agree that the Code should continue to include Provisions regarding going concern and viability statements, but we do not support reducing the reporting requirements in respect of viability.

1. Benefits of an intentional approach to assurance, led by the AC

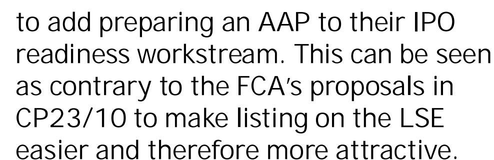
We are supportive of the Government's proposed reporting measure to articulate an AAP – it is likely to introduce meaningful discipline over existing practices, which may be more informal or ad hoc. The AAP implementation report will help address the 'expectations gap' relating to the responsibilities of the auditor regarding disclosures within the front half of the ARA and provide clarity on the extent to which assurance over the directors' declaration over RM and IC has been obtained. It may also create a platform for engagement with investors on the topic of assurance.

We also expect there to be significant connectivity between disclosures in the AAP related to how a company is proposing to strengthen its internal audit and assurance capabilities and how the basis of the new directors' declaration over RM and IC proposed in the Code evolves over time.

2. The Code should not bring the AAP into scope for all Code reporting companies

Whilst we are supportive of the AAP (as noted in 1 above), we would advocate for the Code not to explicitly bring the AAP into scope for all Code companies at this time, for the following reasons:

- The proposed expansion in the description of the work of the AC to include reference to assurance commissioned by the board should in itself drive better accountability and clearer reporting. This could potentially cross-reference the AAP in guidance or as a footnote, in a similar way to the approach adopted in the Code for the RS.
- Cognisant of not introducing new reporting burden too broadly, the Government limited the application of the proposed reporting measures (including the AAP) to 750:750 companies. We believe the FRC should remain consistent with this policy choice, and not require all Code companies to prepare an AAP. While we understand that companies can chose to explain why they have not prepared one (under the 'comply or explain' principle of the Code), many Code companies below the 750:750 threshold will likely feel compelled to do so given the stance some investors and proxy advisers take on explanations – which are effectively viewed as non-compliance.
- Including the AAP in the Code will create yet another nuance and seems counter to the Government's intent to rationalise and refresh the UK non-financial reporting framework.
- The AAP is a new reporting measure, not presently required in other jurisdictions. Many companies seeking to list on the London Stock Exchange (LSE) would need



to add preparing an AAP to their IPO readiness workstream. This can be seen as contrary to the FCA's proposals in CP23/10 to make listing on the LSE easier and therefore more attractive.

- The Code applies to all companies listed on the premium segment, regardless of the country of incorporation of the top holding company. Incorporating aspects of UK Companies Act into the Code by reference, detracts from the Code's international stature. In its response to the ISSB's consultation on the methodology for enhancing the international applicability of the Sustainability Accounting Standards Board (SASB) Standards and SASB Standards Taxonomy updates, the FRC recommended that "by replacing jurisdiction-specific references with internationally applicable definitions, the ISSB would achieve its objective to enhance the international applicability of the metrics (...)." We consider that the same applies to referencing the AAP, and we would furthermore encourage the FRC to remove references to s172 for the same reasons. This could be replaced by instead linking to the expansion of environmental and social themes that is being proposed.

3. Clarity on the interaction between the resilience statement and the viability and going concern Provisions of the Code

We welcome the clarity that preparing a RS will address the current Provisions relating to going concern (Provision 30) and viability reporting (Provision 31).

4. The requirement for all Code companies to report on future prospects should be maintained

As the Code is rightly not proposing to mandate a RS, we are of the view - similar to our comments on the AAP - that the first part of the second sentence in footnote 14 i.e., "For companies not subject to section [xxx], the board should report in a similar and proportionate way to the requirements of this section" should be removed.

The requirement in existing Provision 31 to set out the period over which future prospects have been assessed and why, should be retained to ensure that all Code companies which are not preparing a RS continue to report on their future prospects. The importance that investors place on this reporting, especially during times of global economic uncertainty, was clearly highlighted during the COVID-19 pandemic.

The second part of the sentence in the aforementioned footnote i.e., for an explanation of the basis of the assessment, should be in the body of revised Provision 32 rather than a footnote.

To a great extent, the RS is being introduced as a result of concerns that viability reporting was not fully meeting its objectives. We would advocate that existing Provision 31 should be enhanced to explicitly reference what scenarios have been considered by directors and their outcomes. This would also echo several FRC and FRC Lab reports on better viability reporting. Whilst not part of this consultation, we would recommend that the FRC's guidance on the RS clarifies the expectation around disclosing scenarios beyond the reverse stress test. This is especially important given that the draft secondary legislation on the RS does not explicitly require that companies provide visibility into viability scenarios, beyond the reverse stress test.

# 3. Narrative reporting and non-financial metrics

(Relevant consultation questions 2, 12)

Headline points of view

- ► We support enshrining consideration of environmental (E) and social (S) matters into the Code but are against introducing a climate emphasis.
- ► We support oversight over narrative reporting but are against allocating this responsibility to the AC by default.

## 1. We support the integration of environmental and social matters with broader strategy

We are supportive of the changes to Provision 1 requiring that boards describe how environmental (E) and social (S) matters have been taken into account in the delivery of strategy. Our analysis of plc reporting indicates that most companies already address these matters, and the expansion of the Provision should hopefully result in better articulation of how activities being undertaken in these areas link to a company's strategic objectives – an aspect of reporting that would benefit from improvement.

We do not however support the inclusion of the words 'including a company's climate ambitions and transition planning,' as these concepts are already encompassed within the term 'environmental.' Whilst we fully acknowledge the global importance of climate change, we believe it should be for the boards to decide which aspects of the E and the S are most material in the context of their organisation.

This is also essential for the Code to remain a high-level, principles-based Code. Specifically calling out climate ambitions and transition planning may inadvertently result in increased volume of reporting on those aspects to the detriment of other areas that may be more fundamental to the delivery of strategy, therefore obscuring the overarching aim of the ARA being fair, balanced and understandable (FBU).

## 2. We support oversight over narrative reporting whilst emphasising the need for definitional clarity

We are also supportive of the Code introducing a new emphasis on monitoring the integrity of narrative reporting, which aligns to the scope of internal controls being expanded from 'financial' to 'reporting.' We note however that the term 'sustainability matters' is not defined in the Code. We would encourage the FRC to move away from using this term in the Code and instead focus on 'narrative reporting and non-financial metrics', because in many industries, there are metrics that are not associated with ESG or sustainability nor derived directly from audited financial statements, but which are of critical importance (e.g., CET1 ratios in banking, net promoter scores and number of users/customers in several industries). Guidance could then be used to clarify that

narrative reporting encompasses commentary relating to E and S themes.

If the term is nonetheless maintained, we encourage the FRC to define its meaning in the guidance to ensure consistency across companies. There is ambiguity in the common understanding of terms such as 'ESG' and 'sustainability', with the terms often used interchangeably, despite being similar but not the same in meaning. Furthermore, sustainability is often considered not to cover matters related to governance, focusing on the 'inside-out' perspective of the E and the S.

3. The boundaries of narrative reporting should be defined

The proposed changes do not clarify the boundaries of narrative reporting under the AC's remit. Whilst we acknowledge that the Code is meant to afford companies the flexibility to determine what is material in their context, the lack of such a boundary may create unintended complexity in reporting whether or not the Provision has been complied with. Will an AC who oversees narrative reporting within the ARA, but does not oversee the integrity of a standalone sustainability report, be compliant with Provision 25? Or will it be required to explain why it does not oversee all other forms of external narrative reporting?

Restricting the boundaries to the ARA will also create consistency with the draft secondary legislation on the AAP (which the Code proposes to incorporate by reference). If the boundary is limited to the ARA, companies are of course free to do broaden the scope should they wish.

4. The board should determine the most appropriate delegation of oversight over narrative reporting

It feels too prescriptive to allocate this responsibility by default to the AC, as opposed to it being a board-level responsibility which it can delegate to its committees in a manner that is best aligned to a company's governance structures. Our recommendation also aligns to the requirement in the current Code for boards to assert that the entire ARA is FBU – it is board level responsibility which may be delegated.

Whist monitoring the integrity of non-financial metrics might in practice sit most naturally with ACs, narrative reporting is significantly broader than metrics. In recent years, companies have been evolving their governance and forming board-level committees beyond the three core committees required by the Code. A company that has a committee dedicated to people matters may consider that committee to be better placed to assess the integrity of the people narrative.

The 'comply or explain' nature of the Code does mean that in such cases an explanation of the circumstances would suffice. However, we consider a more meaningful solution would be to introduce a requirement for companies to set out their governance over E and S matters, including how the integrity of related narrative reporting is ensured.

In a similar vein, we would advocate that the FRC's Guidance relating to current Provision 27 – which requires directors to state that they consider the ARA is FBU – reinforces that the assessment needs to cover narrative reporting and non-financial metrics, including on environmental and social matters.

# 4. Director appointments, succession plans and board performance reviews

(Relevant consultation questions 4, 5, 6, 7)

Headline points of view

- We support significant appointments having to be disclosed.
- We support that annual performance reviews must consider director capacity, but we do not support the introduction of disclosures which are likely to lead to more boilerplate.
- We consider that the requirements around diversity in the Code should be kept high-level and directional.

## 1. We support some of the proposed disclosures but caution against boilerplate

We are supportive of changes to Principle K in relation to considering significant external commitments as an explicit part of board performance reviews. This should give stakeholders additional confidence in the conclusions being reached about the directors' capacity to discharge their duties.

However, we consider that the proposed change to the existing Provision 15, requiring an explanation of how each director has sufficient time to undertake their role effectively, is unnecessary and most likely to result in boilerplate statements that will provide little to no value to the users of the ARA. In our view, director capacity is not impacted solely by their other appointments.

As such, we consider that the change to Principle K is a more effective way of increasing the rigour of assessing capacity. Additionally, current Provision 15 already requires that the "reasons for permitting significant appointments [are] explained in the annual report". If a further change to underpinning Provisions is required, it could be reflected within Provision 23 to clarify that the outcomes of board performance reviews, whether internal or external, should specifically address the issue of capacity.

## 2. The requirements around diversity in the Code should be kept high-level and directional

The introduction of the Diversity Listing Rule[2] is increasing the pressure on nomination committees to consider specific characteristics – namely sex/gender identity and ethnicity – in their appointment decisions, so as to ensure they meet the targets that have been set and avoid investors voting against the reappointment of the chair of the nomination committee (and sometimes the chair of the board). We acknowledge that the proposed changes to Principle I require companies to consider diversity in its broader sense. However, in our view, the reference to 'protected and non-protected characteristics' is unnecessary. We consider that the

[2] LR 9.8.6R(9) and LR 14.3.33R(1)

requirements around diversity and inclusion in the Code should be kept high-level and directional, with a focus on cognitive and interpersonal skills, rather than duplicating the requirements of recently updated Disclosure Guidance and Transparency Rule (DTR) 7.2.8A R(1). This is in line both with the FRC's intention for the Code to remain principles-based but also with the Government's aims to refresh and rationalise non-financial reporting. More broadly, the FRC should also consider the impact that such additional requirements (or nuances to existing requirements already set out in other law or regulation) have on the attractiveness and competitiveness of the UK as a listing destination.

# 5. Other changes

(Relevant consultation questions 1, 11)

Headline points of view

- We support codifying the requirement to explain non-compliance with the Code's Provisions.
- We support the spirit of moving governance reporting away from being focussed on process and also support enhanced reporting on culture.
- We do not support mandating topics of AC engagement with stakeholders and warn against unintended consequences of replacing Code Provisions with reference to the Standard.

## 1. We support codifying the requirement to explain non-compliance with Code Provisions

We are supportive of a specific reference to the 'comply and explain' nature of the Code in the body of the Code rather than just its preface. However, we recommend it is codified as a Provision - rather than a Principle - which also requires companies to clarify whether the departure is temporary in nature (i.e., it is the directors' intention to comply with the provision in the near term) or whether the departure is more permanent in nature. In the latter case, the explanation should explicitly set out why the alternative governance mechanism that has been adopted is more appropriate in the specific context of the company.

In our view this differentiation is important given proposed changes such as the introduction of the Standard, which will remain voluntary for companies that are either not UK-incorporated or not part of the FTSE350 and also the FRC's proposals for example around AC responsibility over the integrity of narrative reporting or for all Code companies to prepare an AAP.

We therefore propose a new supporting Provision: *Where the board reports on departures from the Code's Provisions, it should provide a clear explanation including whether these are temporary or permanent in nature. In the case of permanent departures, the board should explain what alternative governance mechanism(s) are in place and why it considers that they are effective.*

## 2. We recommend governance reporting focussed on activities and actions, rather than outcomes

We agree that currently governance reporting tends to be largely process-oriented. As such we support the spirit of moving away from being focussed on process but are of the opinion that the FRC will need to provide clear guidance on what it considers as 'governance outcomes'.

In our opinion, a better alternative would be for companies to provide narrative on the activities undertaken by the directors during the year and the resulting actions/decisions.

This would also address the point that not all governance processes result in discrete outcomes or often the outcomes are achieved over a longer period (e.g., through the strategy

period) and therefore difficult to report on annually.

In line with our suggestion, we propose the following wording for a new Principle:

*Principle: When reporting on its governance practices, the board should focus on activities undertaken during the year and resulting actions and decisions, not only processes, in order to demonstrate how governance contributes to the long-term sustainable success of the company.*

This also links to the framing of a successful company that is led by an effective board in Principle A.

Expanding the requirement in Provision 2 to include reporting on how effectively the desired culture has been embedded, is, in our opinion, a meaningful change. Reporting in this respect continues to be limited, and this addition dovetails with the move to activity and action-oriented governance reporting.

3. Directors should have the discretion to undertake relevant stakeholder engagement

We do not consider that the change to Provision 3, i.e., to report on the engagement that has taken place with shareholders, is necessary. In fact, the shareholder engagement narrative is already well-evolved and an integral part of reporting. Rather we would suggest that Provision 5 be amended to refer to both 'other stakeholders and shareholders.' This change will avoid any potential misconception that reporting on engagement with shareholders requires disclosure separate from that which is currently commonly addressed through s172 reporting.

For similar reasons we do not consider that it is necessary to expect ACs (in Provision 26) to engage with stakeholders on their role, the scope of work of external audit and the AAP. We consider that engagement topics should be based on issues that matter to the organisation's stakeholders. In a stable year, engaging on the scope of work of the external auditor, which is likely to have remained fairly consistent, might not be necessary or result in insightful feedback. Equally as engagement is a two-way process, while ACs may try to engage, they may not be successful. Therefore, if this Provision is nevertheless maintained, it should be worded as "ACs should seek to engage…"

More broadly, engagement of boards with shareholders and other stakeholders is already covered in Principle C, and boards and ACs should have the discretion under this Principle to undertake engagement that is relevant and appropriate in a given year.

4. There are unintended consequences of incorporating the Standard by reference into the Code

Whilst in principle avoiding duplication is important, there are a number of unintended consequences of referencing the Standard in the Code:

- Firstly, the Standard will not be mandatory for non-UK incorporated entities or for companies outside the FTSE 350. If such companies choose to comply with parts but not all of the Standard, it is unclear whether they would be able to claim compliance with the Code's Provisions.
- Secondly, not all provisions within the Standard will be relevant to a company each year. For example, provisions relating to the tendering of the external audit will not apply unless a tender has taken place (broadly a once in ten years event). This may again create uncertainty around the wording needed to accurately explain compliance with the Standard in the context of broader Code compliance.
- Thirdly, if a non-FTSE 350 company chooses not to comply with the Standard (on the basis of the FRC's policy approach set out in paragraph 44 of the consultation), it would not have to report on "significant issues considered in relation to the financial statements and how these have been addressed" as this has been removed from draft Provision

27. This would be at odds with the extended audit report of such companies and more broadly, we consider this would be a real backward step in AC accountability and transparency. As this disclosure is not relevant to the scope of the Standard which deals with auditor appointment and oversight, we encourage the FRC to remove it from the Standard and reinstate it into the Code.

- Lastly, companies will now have to consider two separate documents – the Code and the Standard – further complicating the requirement landscape, especially for non-UK incorporated companies seeking to list on the LSE.

We also request the FRC to clarify why it has chosen not to remove bullets on promoting effective competition during tendering and developing and implementing a policy on non-audit services (bullet points seven and eight respectively in Provision 27 of the draft Code) which have already been incorporated in the Standard. Furthermore, the eighth bullet to a great extent creates duplication with the expected requirements of an AAP.

# Appendix A Responses to questions regarding 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?

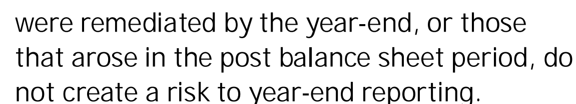
The very nature of the changes being implemented through the UK CG Code and supported by non-binding guidance makes the proposals more flexible than a legislative approach. At this point it is difficult to conclude the extent to which the proposed amendments strike the right balance in terms of strengthening RM and IC and maintaining proportionality, as the guidance which will underpin the basis for the new reporting is yet to be developed and provided to those in the ecosystem. Our understanding is that the FRC does not intend to consult separately on the guidance. We would welcome being able to provide our input but, in the meantime, have set out our thoughts on its contents in the table below.

Having a single declaration covering the entirety of RM and IC systems, now expanded to also cover non-financial reporting, may be a significant undertaking for many who will claim that this is a disproportionate burden. This could have the unintended consequence of diluting the declaration to the lowest common denominator, especially if companies feel under pressure to make substantial progress across all aspects. We therefore consider that a phased approach to implementation would be more proportionate than the current proposals. We advocate for initially limiting the directors' declaration on effectiveness to address ICFR only, whilst retaining the current 2018 Code requirements i.e., i) to monitor the company's risk management and internal controls systems and, ii) at least annually, carry out a review of their effectiveness and report on that review in the annual report. A focus on ICFR would align to the proposed AAP legislation as well as DTR7.2.5 which requires the disclosure of "the features of internal control and risk management systems in relation to the financial reporting process". Directors always have the option to do more if they so wished, by providing a declaration over the effectiveness of the entirety of their risk management system and other elements of internal controls (operational and compliance and non-financial reporting).

A requirement to declare the effectiveness of the broader RM and other elements of IC (operational, compliance and NFR) could be introduced on a phased basis, taking learnings from the declaration over the effectiveness of the ICFR. This phased approach would align with the spirit of the AAP that provides a three-year forward look on how internal assurance activities will be evolving. It would also take into account impending reporting developments coming down the line giving companies time to embed controls over these new areas before having to consider declaring their effectiveness. There are also some calls to delay the implementation date (e.g., to 1 January 2026) to allow companies more time to prepare for the single declaration. A phased approach will avoid further delay and ensure companies make a start.

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?

To avoid creating confusion around cut-off and inconsistencies with the US SOx regime, we advocate that the declaration is based on control effectiveness as at the balance sheet date. Whilst we acknowledge that the situation is different for risk management and operational and compliance controls, as far as reporting controls over information in the ARA are concerned, our view is that material weaknesses that arose during the year but



were remediated by the year-end, or those that arose in the post balance sheet period, do not create a risk to year-end reporting.

Furthermore, if the declaration has to reference effectiveness 'throughout the period', any material weaknesses identified and remedied during the year will still result in an overall conclusion that controls were not effective.

The FRC should also consider clarifying in the guidance that any material weakness or major issues with RM and IC systems encountered in the period between the balance sheet date and the publication of the ARA should be assessed to ascertain whether they qualify as important enough to be captured through post-balance sheet event reporting.

Given the reference to continuous monitoring it is unclear what extent of monitoring would be required to give directors confidence to make a declaration that controls were effective at every point throughout the period and the cost implications of this for companies. Reasonably defined monitoring (performed at statistical and judgemental intervals rather than on a continuous basis) should therefore be one of the inputs into the basis for allowing directors to make a declaration about effectiveness as at the balance sheet date.

In its November 2022 Review of Corporate Governance Reporting, the FRC emphasised that "Good reporting should include details on how the board monitors these systems on a regular basis, in addition to a formal annual review. We favour the use of the term "regular monitoring" rather than "continuous monitoring".

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?

We are supportive of expanding the scope of controls to include controls over NFR, as this reflects the growing importance of narrative reporting and non-financial metrics. However, we urge the FRC to clarify the "boundary" of NFR by defining whether it is limited to what is contained in the ARA or whether it also includes NFR in other statutory and non-statutory reports too, as determined relevant by the directors. Examples might include stand-alone sustainability reports, modern slavery statements and gender pay gap reporting. This clarification is important in the context of declaring the effectiveness of NFR controls, given many of these reports will not be produced concurrently with the ARA. At least initially, therefore, it may be appropriate for the Code to limit the boundary to the ARA, whilst acknowledging in the guidance that directors can expand this if appropriate.

There must also be a recognition of the fact that internal controls over narrative reporting and non-financial metrics, especially metrics relating to environmental and social topics, are significantly less mature. Hence, we reiterate our position above, that initially the declaration should start with ICFR and then be broadened on a phased basis.

If this phasing is not implemented, we would encourage the FRC at the very least to clarify in its guidance, that the directors' declaration can be tailored to address each component of RM and IC (risk management, financial reporting, non-financial reporting, operating and compliance) separately. In our view this will result in reporting that is more precise and decision-useful than a blanket declaration over all elements, which we believe would lead to a lack of clarity around how monitoring and effectiveness reviews differed between the risk management and the various aspects of internal control.

There could also be situations where there are numerous material weaknesses in one element (such as NFR) and therefore an overall declaration is not possible. Additionally, foreign private issuers are likely to want to include reference to the SOx opinions over ICFR in the basis for declaration.

That will not however be relevant to their non-financial 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?

We support improving the robustness of risk management and internal controls, and agree that the proposals to achieve this through reporting enhancements reflect the Government's aims. We are however concerned about the consequences of the guidance underpinning the new requirement not referencing a framework against which controls can be assessed and/or not being prescriptive enough (p21 of the consultation document). In our view, it is imperative that the guidance is sufficiently explicit to provide clarity on the minimum or baseline expectations for:

a. Directors to be able to make the declaration on effectiveness

b. External assurance to be obtained.

In the absence of this:

- We fear that market practice will vary considerably as some companies take advantage of the flexibility that is being afforded. Far from giving investors clarity on the strength of a company's RM and IC systems, it might lead to 'false comfort' if unsubstantiated declarations are made to tick a reporting box.
- It is unlikely that the external auditor will be in a position to provide assurance over ICFR, and there will be a risk of the audit expectation gap increasing and contributing to the 'false comfort'. It would be sub-optimal for the audit and assurance profession to inadvertently have to fill the void in absence of clarity from the FRC. This may also mean that the bar is not set at the appropriate level and will likely differ from one provider to the next.
- The ambiguity faced by companies trying to determine how much is enough, could drive unnecessary cost and effort which impacts on resource and capital allocation and ultimately UK competitiveness and growth. This was the case in the early days of implementing US SOx when projects were over-scoped.

Given the varying degree of maturity of the various constituents of RM and IC systems, we would also encourage the FRC to clarify how those expectations may vary across risk management and the various areas of internal control.

Additionally, it should be noted that, given the optionality of assurance, the cost of its provision would be considered a non-audit service and contribute to the 70% non-audit services fee cap. We therefore encourage the FRC to engage with the Government to clarify this situation, as it may discourage companies from seeking external assurance over ICFR and will create a disadvantage in this respect between companies required to comply with US SOx and others.

Q17: Do you have any proposals regarding the definitional issues, e.g., what constitutes an effective risk management and internal controls system or a material weakness?

We advocate that the definition of 'material weakness' is aligned as closely as possible to the definitions in other existing international standards including US SOx and the auditing standards. However, as the term is to apply beyond ICFR, it is important when defining materiality, to take into account broader factors rather than just a quantitative benchmark.

We also recommend that the FRC introduce a definition of significant deficiencies. This term will help facilitate debate on the subset of deficiencies that may not yet meet the material weakness definition but that warrant specific and further consideration by the board.

We also note that the current proposed wording refers to both 'material weakness' and 'failures.' We are unclear on the need to

reference 'failures' and request the FRC to either delete it or define it.

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

The table below sets out detailed thoughts on what we believe it would be helpful for the guidance to contain and address. Other than these points of detail, we have the following thoughts.

*Level of executive and non-executive involvement in monitoring*

We acknowledge that joint responsibility is fundamental to the unitary board approach. However, in our view this does not equate to all directors being expected to participate equally in discharging all of the board's duties. In fact, the existence of board committees and specific skills requirements highlights why delegation is necessary in order to achieve the right governance outcomes. We would therefore recommend that the guidance sets out the level of involvement that would be appropriate from executive vs non-executive directors as regards monitoring.

*Annual review of effectiveness - part of the basis of the directors' declaration?*

Another aspect that we suggest is clarified, is whether the requirement to report on the annual review of the effectiveness of risk management and internal control systems (unchanged from extant Code) is essentially part of the basis for the directors' declaration rather than being a separate disclosure (this is how it reads currently). If they are separate requirements, the guidance should explain how these two disclosures are expected to differ.

*Clarifying distinction between a RM vs IC framework and what constitutes assurance over the RM aspects*

We would like the FRC to clarify what constitutes a RM framework vs an IC framework as the declaration is to cover both aspects. Whilst these terms are often used in combination and there is a degree of overlap, there are actually important distinctions between the two. RM should cover the overall risk governance 'architecture'; risk identification; assessment and measurement; monitoring and reporting. Managing and mitigation activities could be either a RM or IC activity, depending on the nature of mitigation or monitoring.

We would also recommend that the guidance provides examples of activities that would constitute external assurance over the risk management system, in addition to assurance over IC systems.

| Focus area | Commentary |
| --- | --- |
| Committee of Sponsoring Organizations (COSO) framework as default | We recommend explicitly identifying COSO as the default framework<br>► This framework covers the five elements set out in paragraph 70 (first bullet) of the FRC's consultation. It supports:<br>► greater credibility, as the most dominant framework internationally used in Japan, Korea, South Africa and the US to support their SOx-type regimes. This framework has been tested and refined over years<br>► consistency and comparability<br>► proportionality based on individual company needs and adaptability to new requirements<br>► efficient internal and external assurance, as the foundation is established.<br>► The COSO framework is already well understood by many directors and is proactively evolving to incorporate new requirements. For example, in March 2023, COSO issued supplemental guidance for organisations to achieve effective internal control over sustainability reporting. This leverages the significant knowledge from applying the existing globally recognised COSO Internal Control-Integrated Framework to financial reporting.<br>► Promoting a common, established and adaptable framework will help to future-proof the investments made by companies in establishing or enhancing their risk management and internal control frameworks.<br>► Supporting methodology training and guidance is readily available to help more easily educate and upskill those who are applying the framework for the first time in their company.<br>► The COSO framework would also assist in identifying material controls, as controls can be mapped against the principles and any gaps or enhancements identified. |
| "Continuous" to "regular" monitoring | We propose that 'regular monitoring' may be a more proportionate and appropriate term than 'continuous monitoring'<br>► Typically, controls monitoring is performed cyclically based on statistical and judgmental intervals that reflect the nature and significance of the control, rather than on a continuous basis – i.e., 'without a break or interruption'.<br>► There are concerns that 'continuous' monitoring is a big step beyond what is required today by US SOx. We suggest explicitly clarifying this expectation to ensure undue effort isn't made or if a different expectation is being set - this is universally understood.<br>► In its November 2022 Review of Corporate Governance Reporting, the FRC emphasised that "Good reporting should include details on how the board monitors these systems on a regular basis, in addition to a formal annual review. We favour the use of the term "regular monitoring" rather than "continuous monitoring". |

| Focus area | Commentary |
| --- | --- |
| Support for the use of the Material Weakness definition | Provide more guidance to support the application of the definition of 'material weakness'<br>► The guidance currently states that the definition of material weakness is "in line with other existing definitions of material weaknesses" and references the Public Company Accounting Oversight Board, COSO and UK auditing standards.<br>► Consider strengthening the wording to make it explicit that breaches in financial reporting controls that would be classified as a material weakness under these other standards or regime would also be a material weakness under the Code.<br>► Provide illustrative examples of what may constitute a material weakness for operational, compliance or other non-financial reporting controls and risk management processes to help set expectations.<br>► Without the above and given the broad wording in the material weakness definition especially "…objectives is adversely affected", we believe companies are likely to avoid using this classification or that it will be applied inconsistently. |
| Introduce the "significant deficiencies" classification | A 'significant deficiencies' classification better facilitates transparency and debate at the board and helps align to existing standards<br>► The guidance proposes definitions for 'material weakness' and 'deficiencies'.<br>► We would suggest also including a definition for 'significant deficiencies'.<br>► A significant deficiency in internal control has already been defined in International Standards on Auditing (ISA UK 265 5b) – "A deficiency or combination of deficiencies in internal control that, in the auditor's professional judgment, is of sufficient importance to merit the attention of those charged with governance."<br>► This concept is also well established under US SOx methodology.<br>► The identification of deficiencies as 'significant' is useful, as this effectively highlights and facilitates debate on the subset of the population of deficiencies for operational, compliance and reporting controls and risk management processes that may not yet meet the material weakness definition but warrants specific and further consideration by those charged with governance. |
| Clarify the range of internal assurance options | Broaden the guidance to recognise that other internal risk and independent testing teams, not just internal audit, could provide assurance<br>► A number of larger, complex companies have skills across their lines of defence that could (and do) support the declarations and assurance process. These often include dedicated ICFR controls testing teams and compliance functions. |

| Focus area | Commentary |
| --- | --- |
| Expectations on evidence underpinning the declaration | Set expectations on the level of evidence required to support the basis for the board's declaration<br>► The FRC's guidance will help companies report against the Code's amended requirements, including: "Explaining the basis for the declaration, including how these systems have been monitored and reviewed during the reporting period, and how the board is content that their conclusion regarding the effectiveness of the systems is appropriate." We suggest setting out expectations for the extent and nature of evidence and other documentation supporting the declaration, to the extent that this is not covered as part of the company's chosen framework, such as COSO. |

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