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Dear Financial Reporting Council

Consultation on the UK Corporate Governance Code

We welcome the opportunity to comment on this important consultation on proposed changes to the UK Corporate Governance Code ('the Code'). We set out below some general comments in response to the Consultation, followed by more detailed responses to the individual questions.

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General comments

Risk management and internal controls

We continue to support Board confirmation of the effectiveness of internal controls over wider operational and compliance risks in addition to those over financial reporting. We believe that the proposals should result in a more nuanced discussion than a simple binary statement around the effectiveness of internal controls over non-financial information. However, we note that it is likely there will be widespread disclosures where companies do not fully comply with respect to the effectiveness of internal control over non-financial reporting in the early years of adoption given the relative immaturity of such controls compared to those over financial reporting, and regulators and the market should recognise this is the case.

We also believe that a suitable framework for internal control should be developed by the FRC working in conjunction with the business community, auditors and others in a manner similar to that adopted for the Turnbull Report two decades ago. This framework should be supported by thorough, high-quality guidance and practical examples to support implementation.

Scope of application of the Code

The successful adoption of the Code is based on setting an appropriate scope of entities which should be subject to its requirements. However, there is significant complexity in current reporting requirements for listed and/or large companies with different thresholds set for the application of the Code (Premium Listed), reporting requirements of the Wates Principles (2000/£2bn/£200m), Non-financial information statement (PIE + 500 employees), climate related disclosures (PIE/AIM/£500m + 500 employees) and the recent Statutory Instrument laid before Parliament set out additional requirements for companies with high levels of employees and turnover' (CHLEATs) (750 employees/£750m turnover). We note that AIM companies are also required, by the AIM rules, to declare and apply a corporate governance code and the QCA code is widely used here.

The inclusion of some very large private companies in the revised 750/750 PIE definition suggests a recognition of the need for strengthening the expectations relating to their corporate governance. However, it is clear that the current arrangements have developed piecemeal over many years and are long overdue a holistic review to streamline the thresholds and associated requirements, assessing which code(s) apply to which companies and the issues to be covered by them, to ensure that the extent and complexity of requirements is in proportion to the benefits of applying and reporting on them.

We appreciate that such a review is not entirely within the FRC's control. However, the FRC should be mindful of the current reporting requirements when considering the appropriate threshold for application of the code, so as to avoid adding yet more complexity.

Reporting requirements – the Code vs. SI requirements

It is important to consider the links, and consistency, between the requirements on CHLEATs set out in the proposed Statutory Instrument with those in the revised Code. The Government has set out in the SI those requirements that should apply only to 'CHLEATs' (e.g. audit and assurance policy, resilience statement, dividends and fraud disclosures). However, the FRC appears to be extending Government's intention, incorporating additional reporting requirements in some areas in the Code, thereby expanding the scope of application of some of those reporting requirements to a wider range of Companies.

It is not clear whether this approach has been considered thoroughly and consistently applied, and the FRC has not explained/justified why some elements of SI are incorporated into the Code, thereby applying to listed entities which do not meet the CHLEAT definition. For example, the Audit and Assurance Policy is incorporated in the Code, whilst other requirements, such as the material fraud statements, are not. In publishing the final version of the Code the FRC should publish its reasoning for its treatment of reporting requirements in the SI in a basis of conclusions document.

Importance of guidance

The successful implementation of the revisions to the Code will rely heavily on high quality guidance made available to companies from the outset of adoption of the Code. This is particularly, though not exclusively, true for the requirements relating to risk management and internal controls. The absence of guidance alongside the proposed revisions to the Code is disappointing and makes it difficult in some instances to respond effectively to the questions posed in this consultation as the quality of the guidance will be critical to adoption.

Recognising that the Code applies to a wide range of companies, the guidance needs to be scalable to enable companies to develop disclosures proportionate to their size and complexity, and to reflect the risks they are addressing.

Potential impact of the revised Code on availability of Directors and diversity

The ever-increasing requirements on, and expectations of, Boards and Audit Committees in terms of time commitment, skills and knowledge (e.g. sustainability oversight and reporting, more engagement with stakeholders, reporting on effectiveness of internal controls) may have an unintended consequence of reducing the number of potential candidates for Board roles, in a similar way that regulatory pressures are seemingly having an impact on new entrants to the audit market for PIEs. This impact may be further exacerbated when ARGA is established with greater powers to hold Directors to account. This may also have an unintended impact on the ability of Boards to effectively improve diversity and inclusion.

In light of the above, consideration should be given by the FRC to how it, and subsequently ARGA, can best maintain the attractiveness of board roles through the adoption of a proportionate improvement-orientated regulatory regime.

Avoiding boilerplate disclosures

The Code should have a focus on meaningful communication of the Board's overall approach, priorities and outcomes, what the Board has spent its time on and what are its areas of concern. Although we broadly welcome the proposed changes to the Code, as noted in some of our responses below, we have a general concern that, in the absence of high-quality guidance and practical examples to support implementation, boilerplate disclosures may remain prevalent in some cases, lessening the impact of the changes to the Code and the value of corporate governance reporting.

Importance of legislation establishing ARGA

We are supportive of the drafting of a revised Code. However, without the legislation establishing ARGA as the new regulator, there is a risk that the changes will not really be an effective means of ensuring all Boards take full action to implement the changes (the "last 10%" referred to by Sir Jon Thompson in his presentation to the Institute for Government). It is therefore crucial that the audit reform legislation progresses as soon as possible.

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

We support the focus on "activities and outcomes to demonstrate the impact of corporate governance practices" and the intention to deliver more outcomes-based reporting, however greater clarity is needed as to what is meant by "outcomes" which are often difficult to demonstrate, measure and attribute to a particular action.

The aim of the constructive challenge and support of the Executive in this corporate governance framework is to achieve an appropriate balance of focus on enterprise and accountability leading to the outcome of an ongoing sustainably successful business providing benefits for its stakeholders including wider society. It is not immediately clear from the proposed Principle D in the Code how this desired outcome can be expressed meaningfully and avoid the use of generic, boilerplate language. Companies will need guidance to enable them to report on how they have applied the principles and provisions in the code in focusing on activities, indicating priorities, and associated outcomes. The code provisions could be strengthened by the inclusion of key targets, and progress in achieving them, in relevant areas to set activities and outcomes in context.

If reporting on governance outcomes is to be meaningful, it will be important to provide high quality guidance and practical, proportionate examples of what is expected when linking outcomes to Board actions.

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?

We support the disclosure of how environmental and social factors are taken into account in the setting of a company's strategy. However, we are not persuaded of the need for additional disclosure specifically in the code just on climate change and transition planning as opposed to what may be the specific key environmental and social factors for a particular company.

Whilst we agree that the Board and Audit Committee should take an overall oversight responsibility for climate reporting, we are concerned that the interaction between the code and TCFD requirements, and in the future ISSB Standards, which are likely to be adopted in the UK and which also focus on Governance, Strategy, risk management and Metrics & targets, is not clear. Similarly with transition plans there appears to be a risk of duplication. The FRC should clarify what requirements are additional to those already reported under other requirements, and the benefits of any such disclosures.

The FRC should also provide guidance on how and where relevant disclosures should be made in an integrated and concise manner in the annual report (e.g. through appropriate cross-referencing from the financial statements to other areas of the annual report).

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

We are generally supportive of the changes to Section 1. However, it is not clear why the reference in Provision 2 to providing an explanation of the company's approach to investing in and rewarding its workforce has been deleted given the importance of the workforce as a stakeholder in a company.

Furthermore, in Provision 3, it is not clear why the requirement that committee chairs "should seek to engage" with shareholders has been amended such that they "should engage" with them. This change ignores the reality in practice where company chairs, apart from the chair of the remuneration committee, often find it very difficult to get the attention of investors, especially if they are a smaller listed company. Such engagement is a two-way process, and it is not appropriate to have a clear expectation to engage on one party when the other party may not be willing to engage. Heavily diversified investors will not have the capacity to meet with Audit Committee Chairs of all companies in their portfolio and may be likely to concentrate on larger entities at the expense of smaller companies.

Q4: Do you agree with the proposed change to Code Principle K (in Section 3 of the Code), which makes the issue of significant external commitments an explicit part of board performance reviews?

It is not clear why the FRC's attention is focused on "director's commitments to other organisations". This does not fully take account of the time a director has available, as it ignores related factors such as other personal commitments whether in terms of, for example, caring responsibilities or other interests apart from serving on boards of other organisations. Moreover, we are not aware that this is a significant concern in many instances.

We believe that the focus should be on the second half of the added sentence, and we suggest that the addition to Principle K be revised to state "*The annual performance review should consider each director's ability to discharge their duties*". Guidance might helpfully set out that external commitments (including personal commitments as well as commitments to other organisations) may be a factor in assessing a director's performance, rather than including this as a specific requirement in Principle K.

Furthermore, we consider that further guidance on Principle J would be helpful as present reporting on the Board's function and capability tends to focus on annual/triennial evaluations and skills implied

from previous roles included in biographies. Better mapping of the focus areas of the Board and matching them to capabilities of directors might produce a more meaningful result.

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?

We support greater transparency and directors disclosing other significant appointments held by them, whether in a paid or voluntary capacity, as this provides useful information, for example, on their areas of interest. This requirement should also include any consultancies.

We are not persuaded, however, that meaningful disclosure will arise from calling on them to explain how they have sufficient time to undertake their role effectively given their other appointments for the reasons stated in response to Q4 above.

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

We believe that actions taken by companies and existing disclosures regarding gender and ethnic diversity are beginning to be effective. Furthermore, we note that the FRC is in part reflecting the FCA Policy Statement and looking to avoid duplication.

On balance, we consider that the proposals are likely to be moderately helpful, with particular reference to disclosures on diversity characteristics. However, we believe that it remains very important for there to be a continued strong focus on improving the balance on boards with regard to gender, ethnicity and social backgrounds as much remains to be done in these areas, as well as other areas such as sexual orientation and disability.

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?

In principle, we support the inclusion of reference to protected and non-protected characteristics in the revised Code to generate wider consideration of succession planning and senior appointments. However, we note that there is still more to be done with regard to the currently mentioned characteristic, related to gender, listed in the last bullet point in Provision 23 of the extant Code and also with regard to ethnicity and socio-economic background on which there has also recently been focus in relation to Board and other senior appointments.

If the proposed changes are made, the guidance issued alongside the Code will be important in supporting companies to strike the right balance in their actions and disclosures. For example, Principle I states that *"Both appointments and succession plans should be based on merit and objective criteria and should promote equal opportunity, and diversity and inclusion of protected characteristics and non-protected characteristics including cognitive and personal strengths."* It is not currently clear what is meant by 'non-protected characteristics' in this context – if it is personal strengths, how is that different from 'merit'? If it is something else (e.g. social class) then this needs to be made clear.

Q8: Do you support the changes to Provision 24, and do they offer a transparent approach to reporting on succession planning and senior appointments?

We support the changes in Provision 24 subject to noting that we consider that the bullet point calling for disclosure of the gender balance of those in senior management and their direct reports should at

least be extended to refer to ethnicity as well if it is to be retained in addition to the previous one covering diversity more generally. However, further consideration would need to be given to how ethnicity is described, particularly in the context of international companies.

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?

We support the adoption of the CGI recommendations. As noted elsewhere, the development of high-quality guidance will be critical to successful implementation of the revised Code.

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

We consider that the Audit and Assurance Policy provides useful information on the quality of reporting and so all Code companies should prepare one especially as it is not particularly burdensome to do so. However, please see our comments on the scope of the Code in the introduction to our response letter.

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?

The reference to the Code in these provisions is an effective way of removing duplication in relation to the audit committee's interaction with the auditors. However, we do not believe that it is appropriate to include such references to the standard in the Code at the present time, as the standard is only available for use on a voluntary basis until the anticipated legislation to establish ARGA is implemented.

In terms of the scope of companies to which it applies, the Minimum Standard is addressed to FTSE350 companies only and we note that reference to it in these provisions largely replaces those aspects that relate to interaction with the auditors. We therefore consider that additional requirements in the standard may appropriately be applied more widely to other companies applying the code once the standard has been formally approved by the proposed ARGAs, recognising that they will be able to adopt them on a comply or explain basis.

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?

We consider an integrated approach to corporate reporting by companies, bringing together narrative and financial reporting, is essential in the modern environment. On balance, and after careful consideration, we agree that it would be appropriate for the audit committee's remit to incorporate narrative reporting, especially as it will have responsibility in relation to the appropriateness of systems and controls over such reporting. We note, however, that the burden on audit committees is already considerable, and they may not necessarily have the appropriate skills to address complex sustainability issues. It will be important for the audit committee to liaise effectively with the sustainability committee, or similar, in a company where this exists.

Given our view that the content of the annual report needs to be considered as an integrated whole, we believe that ESG reporting should not be spread across different narrative reports. The audit committee should also be involved in matters such as deciding the extent to which the narrative reporting, including that on ESG, should be subject to assurance.

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?

We note the consultation suggests that the approach to risk management and internal control will “avoid disproportionate burdens” to comply with the requirements around controls given that companies currently report on the system as a whole, rather than focussing on financial reporting only, whilst at the same time claiming that these proposals will significantly enhance corporate governance and controls. Such a step change in the effectiveness of controls and of corporate governance cannot be achieved without significant investment.

We have supported, for a number of years, the need for reporting on the effectiveness of controls. We consider that the board should make a declaration of whether it can reasonably conclude that the company’s risk management and internal control systems have been effective throughout the reporting period and continue to believe that this statement should cover all controls and not just financial reporting controls. However, for the period from the balance sheet date up to the date of the annual report the requirements for reporting should be less onerous and cover relevant disclosures where major issues have come to the board’s attention in a broadly similar way to which events after the balance sheet date are addressed in the financial statements.

Although we agree that the amendments to the Code will, ultimately, strengthen risk management and internal controls, it is important to recognise that controls in some areas, such as those related to environmental and social issues, will generally be less well developed than those relating to financial reporting. As such, in the early years of adoption of the revised UK Corporate Governance Code, there may be less certainty as to the effectiveness of such wider controls. We are concerned that the comply or explain basis may not be sufficient to address such issues in the infancy of adoption of wider controls reporting as companies may be resistant to fully disclosing deficiencies in wider controls.

Under the current proposals there will likely be a number of companies reporting material weaknesses, particularly in respect of non-financial reporting, and it should be accepted by regulators and the markets that this is a better approach than obfuscation and that boards should lay out a timely and effective path to addressing this in the early years. However, there is a risk of Boards “gaming the system” by setting high thresholds for material weaknesses, which may be counterproductive. Furthermore, there is a risk of boilerplate disclosures, particularly in the early years, to avoid making adverse disclosures.

The FRC may therefore consider a phased implementation of the requirements around risk management and internal controls, focussing initially on controls over financial reporting, to enable control environments to mature in a planned and systematic way with regards to wider, non-financial, reporting controls over a reasonably focused period of time.

As directors increasingly make disclosures around internal controls, including potential disclosures of material weaknesses in the control environment, the role of the auditor with regard to such reporting in the annual report may need to be clarified further. Although there is no requirement for assurance on the director’s statement, auditors will inevitably be drawn into reviewing the directors’ assessment of controls, considering its implications for the audit and having to consider whether any of the conclusions need also to be disclosed in the audit report. This may well lead to a significant increase in audit effort, increasing the costs of the audit, and possibly leading to contentious differences of opinion with the Board.

To support companies in adopting the Code and advancing the maturity of controls in the short term, comprehensive high-quality effective guidance supported by practical examples which address the key issues, on reporting as well as maintenance of controls, will be required in advance of the effective date of the Code's adoption. It is critical that new guidance has the strong support of the business community, which we believe would be best achieved through their close involvement in development of the guidance, as was the case for the Turnbull Report. The FRC should consider how best to involve stakeholders, including a leading group of business people (e.g. Chair, FD, other directors), internal auditors, external auditors, company secretaries etc. in developing its guidance, perhaps establishing a Steering Group of stakeholders with staff support from the FRC, reporting into the FRC Board.

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?

We believe the term 'ongoing' rather than 'continuous' monitoring is more appropriate and that this should apply in the case of CHLEATs. Whatever terminology is used, the FRC should provide a clear definition as to what continuous (or an alternative phrase such as ongoing) means in practice. To the extent the Code applies to other companies too, we believe the option should be open for periodic review as an alternative to continuous monitoring, if appropriate given the company's circumstances.

As discussed in our response to Q13, we believe the reporting should be less onerous in the period from the balance sheet date to that of the annual report.

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?

As discussed above, we believe all controls should be covered by the reporting expectation whilst recognising that different controls may be at different stages of maturity upon adoption of the revised Code, which will need to be reflected in the 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?

As discussed in Q13 above, high quality, effective guidance and practical examples will be required in advance of the effective date of the revised Code's adoption to support companies adopting it.

As part of this guidance, it is important that a framework is set out, consistent with the approach of the UK Corporate Governance Code, to help boards assess whether it is reasonable for them to conclude that the system of risk management and related controls have been effective throughout the period covered by their confirmation. Such a framework will be particularly helpful in areas where controls are in many instances still in a period of development such as in relation to sustainability. We set out below some initial thoughts on areas of focus for such a framework and associated guidance:

- Which controls would normally be expected to be covered, in addition to financial reporting.
- As discussed in the consultation document, which items need defining, how they will be defined and what additional guidance and examples are needed when applying the definitions in practice?
- Whether a "three lines of defence" approach is mainly applicable to financial controls or more widely, and if more widely, in what circumstances?
- Identification of good practice principles and the danger signs to watch out for.
- When it would be appropriate to have ongoing review and when a periodic review of the effectiveness of controls, the latter perhaps applying, as mentioned, in the case of smaller companies.

- The role of internal audit with regards to its work on the effectiveness of controls and its reporting to the audit committee/Board.
- What phasing of confirming effectiveness for non-financial reporting controls might be appropriate, including what gets done and disclosed in the interim period before full effectiveness assessments are completed?
- What audit committees should look for and what tasks they should undertake in reviewing the effectiveness of controls.
- The respective roles of the audit committee and the Board in relation to the effectiveness review. For example, would we expect the audit committee to be fully involved given its independent oversight role.
- The implications for skill sets required by, and the work of, audit committees and Boards.
- Any additional disclosures needed to those proposed, e.g. on disclosures related to phasing, and disclosures if the Board and audit committee do not agree with each other, or with the auditors.
- The level and appropriateness of reliance on third party information, particularly in respect of sustainability information where, for example, scope 3 emissions information and items such as conversion factors will be difficult to verify.
- Circumstances in which it may be appropriate for the Board and/or audit committee to seek external assurance on the effectiveness of risk management and internal controls.

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 are broadly supportive of the proposed areas to be covered in the guidance and of the definition of a material weakness. It is critically important that definitions of deficiencies, material weakness and what an effective system looks like are set out. However, these will be difficult matters for Boards to interpret consistently from company to company, and the quality of the guidance and practical examples will be key in supporting effective implementation so as to enable consistency and comparability of reports.

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

We have discussed areas we consider should be covered by guidance in our response to Question 16. In addition, it would be helpful for the guidance to cover the role of resilience statements as part of the system of risk management and internal controls.

It is also not clear why the Code is not covering material fraud statements for companies applying the Code in addition to 'very large companies' which will be required to apply it by the proposed Statutory Instrument. As set out in our general comments, a consistent approach to what is covered by the Code and the SI is important, which is not to say the Code should mirror the SI, but that there should be a logical justification for which parts are carried through from the SI to the Code and which are not, and this should be set out by the FRC in a basis of conclusions.

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)?

We agree that the current provision 30 should be retained.

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

Yes, reporting on future prospects is vitally important for stakeholders.

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?

Yes. However, the quality of such disclosures will be helped by the provision of high-quality guidance to support implementation and avoid boilerplate language.

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

Yes. We welcome the proposed revisions to strengthen the links between remuneration and corporate performance.

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

Yes. We welcome the proposals which we believe will enhance transparency, although we note that these disclosures are already becoming standard practice.

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

We agree with the changes to Provision 41. However, we consider Provision 40 should remain as it sets out helpful guidance on issues for the remuneration committee to consider when setting executive director remuneration though, as proposed, we do not see the need for disclosures on how the key elements in Provision 40 have been applied as we believe the other disclosures should provide insights into whether these elements have been applied in practice. It would be helpful to include the existing Provision 40 in guidance to support implementation of the revised Code as a minimum.

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

We support the provision of appropriate information on pay gaps and pay ratios and consider it would be helpful to have an assessment of whether the current disclosures have had the effect intended. We therefore believe the FRC should undertake an impact assessment on whether the disclosures on pay gaps and pay ratios have been proven to be useful to stakeholders, and, in the light of this review, decide whether the current wording of the provision should be retained or strengthened.

Q26: Are there any areas of the Code which you consider require amendment or additional guidance, in support of the [Government's White Paper](#) on artificial intelligence?

We have no further comments at this stage. It will be important to monitor future developments in relation to Artificial Intelligence and the related potential impact on future revisions to the Code and/or guidance.

Further discussion

If you would find it helpful to discuss any issues in this letter, please contact David Herbinet, Global Head of Audit (david.herbinet@mazars.co.uk) or Paul Winrow (paul.winrow@mazars.co.uk).

Yours faithfully

Mazars LLP

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