Financial Reporting Council
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By email to: codereview@frc.org.uk

12 September 2023

Dear Sir or Madam

UK Corporate Governance Code Consultation

PricewaterhouseCoopers LLP ("We") welcome the opportunity to respond to the FRC's Consultation ("the Consultation") on the UK Corporate Governance Code ("the Code").

A robust system of risk management and internal control is vital to ensure company resilience, fraud prevention and detection, and high quality corporate reporting. Both Sir John Kingman and Sir Donald Brydon, in their 2018/19 independent reviews, recommended strengthening boards' responsibilities for internal controls, so we are pleased that the FRC is moving forward with recommendations in this area, although our strong preference was for measures to be introduced through legislation.

The principles based approach of the Code has many advantages, and it is world-renowned for its strong yet flexible application. However, it has limitations when it comes to holding directors to account, as it is purposefully quite high level and is not readily enforceable. More clarity will be needed over how the FRC will monitor compliance with the Code's Provisions to ensure companies understand the appropriate steps they need to take to improve on what they are currently doing, and that they will be held accountable if they don't take those steps. In our experience, apart from those operating in a SOx or other heavily regulated environment such as financial services, interpretation and understanding, as well as the robustness of application, of the current Code Provisions around risk management and internal control, is varied.

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There are many advantages of stronger internal controls, beyond good governance, and we encourage the FRC to put greater emphasis on such benefits as: improvements over the quality and reliability of financial reporting; enhanced business resilience; combating fraud; and supporting organisational efforts to improve the efficiency and effectiveness of business processes.

Key observations

We agree with many of the proposed updates to the Code, including the following in relation to risk management and internal control:

- *Requiring boards to make a much more robust declaration about the operating effectiveness of the company's risk management and internal control systems* - in particular, asking boards to provide a basis for that assessment and to disclose any material failures. Notwithstanding our observations below, we think this will bring directors' responsibilities in this important area into much sharper focus and, with the right clarity of expectations and enforcement, will have the effect of changing behaviours, culture and mindset around internal controls.
- *Including internal controls over non-financial reporting in the scope of the directors' declaration* - this emphasises the increasingly important role that non-financial information is playing in economic decision making, and the need for this relatively new area to be well controlled.
- *Increasing focus on engaging with shareholders and other stakeholders on the role of the audit committee, the scope of the work of the external auditor, and the approach to the Audit and Assurance Policy (AAP)* - for the AAP in particular, active engagement will ensure a focus on the most important reported information, and that the approach to assurance is sufficient.
- *Enhancing the audit committee's responsibilities over the integrity of narrative reporting and in particular sustainability matters* - this is an increasingly important area for investors and will align with a board's responsibilities around the AAP.
- *Bringing the AAP and Resilience Statement into the Code on a comply or explain basis* - this will effectively bridge the gap between the number of companies that will be required to have these important disclosures by law, and those that would be expected by their stakeholders to have them. We also suggest that the proposed Material Fraud Statement is included in the Code, as this is an equally important disclosure that, in our view, it would be sensible for all premium listed companies to have.
- *Similarly, we agree with the inclusion of 'Audit Committees and the External Audit: Minimum Standard' on a 'comply or explain basis*' as this expands the scope of this new standard beyond FTSE 350 companies.

In general, we agree with the other proposed changes to the Code. In particular, the introduction of a Code Principle specifically on reporting, and the expectation that directors should, when reporting on their governance activity, focus on activities and outcomes, in order to demonstrate the impact of governance practices. The focus on high quality governance reporting, that deals with outcomes rather than simply describing roles, responsibilities and processes, is consistent with a recurring theme we've heard over many years from the PwC 'Building Public Trust Award for governance reporting'.

We have four main observations, particularly relating to the proposed changes to risk management and internal control responsibilities, which are outlined below and covered in more detail in the

appendix. We hope that these observations will be helpful to the FRC in achieving its policy objectives, while at the same time helping to address the concerns we know some companies have over the impact of the changes.

1) *Targeted scoping will be essential - the AAP is a logical framework to use*

Although the coverage of the assessment is largely the same as under the current Code (except for the addition of non-financial reporting controls, with which we agree), the stronger declaration by boards will require a much more robust assessment process. Specific, targeted scoping will be essential in order to ensure this remains proportionate and focused. Boards must first determine what the material risks to the business are in terms of operations, compliance, resilience, susceptibility to fraud and external reporting. In our view, the AAP would be a logical framework to help enable this targeted approach, and we recommend that consideration is given to referencing it as such in the supporting guidance. The AAP is focused on reported information in the annual report, so will provide a valuable way to identify the most important financial and non-financial reporting areas. Going a step further, for most companies we envisage that the AAP will also include the principal operational and compliance risks faced by the company, as described in the annual report, as well as risks to resilience in the Resilience Statement and fraud risks in the Material Fraud Statement. Using the AAP as a framework to help identify these areas and then to map the related key controls, and other 'lines of defence', will bring structure and manageability to the scoping process. It will also bring together many of the different aspects of the reforms in one place, and demonstrate how they work together as a package.

2) *Detailed, appended guidance will be essential*

The objective for the proposed changes set out in the Consultation, in relation to the risk management and internal control framework, is described as "*providing a stronger basis for reporting on and evidencing the effectiveness of the framework during the reporting period*". The changes proposed by the FRC will be a significant step towards achieving this, but only if they are accompanied by detailed guidance on how companies should support the proposed declaration in the Code. This is important as currently, in our experience, there are widely varying approaches to meeting the existing internal controls provisions within the Code. To ensure consistency of application under the revised Code, it would be beneficial for there to be clarity of expectations from the FRC, as to what companies need to do to comply with the updated Code compared to what actions they undertake to meet their commitments today.

Furthermore, without detailed accompanying guidance to drive consistency across the market, there is a risk of increasing the expectation gap between boards and users of annual reports, and potentially creating confusion and inconsistency in the market. This could lead to a loss of trust and transparency, the very things these reforms are trying to enhance.

Guidance will be particularly important when determining what is considered a "material failure". At the moment, it is suggested in the Consultation that this should be left to the judgement of the board. In our view, this could lead to confusion and inconsistency which would undermine the value of the declaration and risk reducing trust and transparency rather than enhancing it. Again, to ensure consistency of application, it would be helpful if the guidance provided clarity about what the board should consider when determining what is material, especially in non-financial areas. It would also be

helpful to have illustrative examples or FAQs that could provide practical guidance on, for example, how often review and monitoring should ideally happen, who would normally be involved, the types of evidence that would be appropriate, and suggestions for an independent testing programme.

Also, given its importance, we suggest that, rather than a separate document, the guidance should be an appendix to the Code, which will give it much more prominence and be easier to access and consult.

3) *Timing*

More clarity is needed about what is meant by “continuous monitoring”, and whether this is expected at the board level or at a level below (i.e. management). Notwithstanding this, we are concerned that the expectation of a continuous assessment process could, for many companies, result in a light touch approach or one that never draws a line in the sand to make a judgement about whether the systems are appropriately effective. Instead, regular periodic assessments (perhaps every quarter or every month - in line with the operation of the material controls) could carry more weight, and support a more robust, in depth assessment at the year end. Maintaining evidence of control operation will be essential.

In our view, the effective date of the declaration should be the year end rather than the date the annual report is approved. This would better reflect how companies operate, as well as the governance and processes that need to be in place to support what will be a very important declaration. It will also be in line with other statements made in the annual report. There could be some additional, lighter “stand back” procedures suggested, to keep the review up to date at the date the annual report is signed, without the full review needing to be at that date.

4) *Auditor responsibilities*

Whilst we recognise the flexibility that the Code allows directors in their approach to controls, it does mean there can be an imbalance with what is expected of the auditor in this area. Although there are no current plans to mandate assurance over the board declaration, or to change the auditor’s responsibilities under ISA (UK) 720[1], we believe there will be an expectation from shareholders, and other stakeholders, that the auditor agrees with the directors’ declaration. We therefore encourage the FRC to consider whether guidance for auditors is needed in this area, especially if the related Code Provision remains one that auditors are specifically required to review under the Listing Rules.

Also, there could be additional challenge of auditors by shareholders on their approach to controls as part of the audit, especially on controls relevant to financial reporting. Consideration could be given as to whether auditors should be required to describe their approach, and possibly their view on a company’s controls, in their audit reports.

In some cases, especially when the AAP is in place, boards could request assurance from their auditors over their internal control declaration. Boards will need to ensure that the basis for their assessment of operating effectiveness is actually assurable. Auditors will need guidance from the

[1] The Auditor’s Responsibility Relating to Other Information

FRC about the most appropriate assurance standard to use and, potentially, the FRC will need to consider whether a new, specific assurance standard around internal controls is needed.

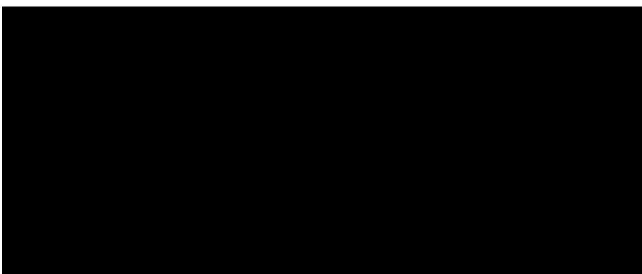
We would also highlight the ongoing PCAOB consultation on auditors' responsibilities for considering a company's non-compliance with laws and regulations (NOCLAR). The PCAOB is proposing to expand the auditor's objectives in this area significantly, which, as a network, we have expressed concerns over. We are aware that the FRC is also planning to consult on the NOCLAR-related UK auditing standards and encourage it to consider any expansion of auditor responsibilities under these standards in light of the additional expectations around auditors outlined above. In particular, whether it would further exacerbate the potential imbalance between director and auditor responsibilities.

Our detailed responses to the questions posed in the Consultation are included in the appendix to this letter.

This is an important part of the overall package of reforms being proposed by the FRC and the Department for Business and Trade. If implemented cohesively, many of the reforms will work together and deliver valuable improvements that will benefit the whole corporate ecosystem. Consideration should be given to the interaction with the changes to the listing regime being proposed by the FCA as part of their Primary Markets Effectiveness Review. In our view, both areas of reform need to be aligned and coordinated to achieve the intended outcome of creating a well governed, well controlled marketplace that attracts issuers to list in the UK.

We hope our comments are helpful and if you have any questions or require any further information, please do not hesitate to contact me at

Yours faithfully,



Appendix - Response to the Consultation questions

<table>
<tr><td>Section 1 – Board leadership and company purpose</td></tr>
<tr><td>Q1: Do you agree that the changes to Principle D in Section 1 of the Code will deliver more outcomes-based reporting?

The introduction of a Code Principle specifically on reporting is, in our view, a positive move. The focus placed on high quality governance reporting that deals with governance outcomes and the value added by the board and its committees rather than simply describing roles, responsibilities and processes is fully consistent with a key message of the PwC Building Public Trust Award for governance reporting, over many years. It also supports the wider FRC and societal focus on outcomes, and will support the directors in demonstrating the impact of their roles and functions. We support a qualitative and quantitative approach to governance reporting.

The Code previously contained no ‘requirements’ about reporting among the Principles and Provisions, and in effect relied on the Listing Rules requirements to drive the reporting, so this will fill a fundamental gap in the Code as a standalone framework.

The 2018 version of the Code included a section in the Introduction on Reporting on the Code (p2), which encouraged meaningful reporting that focuses on how specifically the Principles “have been applied, articulating what action has been taken and the resulting outcomes”. The proposed new Principle covers everything in the Code (including the Provisions), and we support this change.</td></tr>
<tr><td>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 agree that the board should report on a company’s climate ambitions and transition plans where these are significant for its business model and strategy. The current draft of Provision 1 could be clearer on this distinction.

Also, Provision 1 uses the term ‘environmental and social matters’, whereas the second bullet in (new) Provision 26 refers to ‘sustainability matters’, and (new) Provisions 27 and 43 contain references to ESG metrics. It would be useful for the updated guidance to clarify the relationship the FRC sees between these terms.

In our experience, the current version of Provision 1 has often simply generated a cross-reference from the governance section to the discussion of business model and strategy in the strategic report. We recommend that the proposed related guidance makes it clear that the focus here should be on how governance has been applied (per proposed (new) Principle D), rather than on the business model and strategy. In this regard the deletion of how ‘governance contributes’ from the existing Provision is not helpful.

We also recommend that the guidance covers the relationship between this reporting and the governance pillar of the TCFD framework. The content relating to this Provision should, as noted above, focus on the application of governance (to ESG matters where they are strategically significant), rather than describing the governance arrangements as called for in the TCFD disclosure recommendation.</td></tr>
<tr><td>Q3: Do you have any comments on the other changes proposed to Section 1?

Provision 3:
It is proposed that Provision 3 is updated to state that committee chairs “should engage” with shareholders on significant matters in their area, not just “seek engagement”, and report on outcomes. This is likely to remain a challenge for some committee chairs, particularly audit committee chairs, but we would still support the change because, in our view, “seek engagement” is a low hurdle and can result in a limited response, and because it</td></tr>
</table>

is reasonable to expect engagement (on a comply-or-explain basis of course) on matters that are judged to be 'significant'. We recommend that the Code or the guidance should make it clear whether chairs of committees beyond the nomination, audit and remuneration committees are expected to engage. The guidance should also clarify how to make judgements around what is meant by "*regular engagement*" with shareholders, e.g. frequency, minimum level of engagement (including the process to be adopted if there are some shareholders who won't engage), and the appropriate balance between engagement with institutional and retail investors. The FRC should also consider ways to encourage shareholders to engage more frequently. The language of the final sentence of the revised Provision 3 implies that the chair themselves should report on the outcomes of engagement with shareholders, and we question whether it's necessary for this to be the case as long as the related outcomes are reported. Provision 6: Updates are proposed to Provision 6 to have the board review the effectiveness of the whistleblowing system, following on from the change introduced in the 2018 version of the Code to make the whistleblowing arrangements primarily a whole-board, rather than an audit committee, responsibility. This change has not been recognised by every company, and we recommend that the guidance clarifies the expectations, including the addition of the review of effectiveness.
Section 2 – Division of responsibilities
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? This proposed change in (new) Principle K is, in our view, too specific to be a Principle of the Code. It also seems to cross over with the proposed change to Provision 15 around listing all significant appointments of directors and describing how each director has sufficient time for their role. We suggest focusing on Provision 15 and encouraging outcomes-based reporting linked to that Provision.
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 the concept of this Provision, but recommend that guidance is provided on what is meant by a '*significant*' appointment, and the fact that judgement will be needed in responding to this amended Provision. It should also be clear in the guidance how much detail should be provided about directors' other appointments.
Section 3 – Composition, succession and evaluation
Q6: Do you consider that the proposals outlined effectively strengthen and support existing regulations in this area, without introducing duplication? We are sympathetic to the FRC's goal of avoiding duplication in this area between the Code and the DTR in particular. However, in our view this needs to be balanced with ensuring that the Code framework is internally coherent. For example, currently there is no Provision that calls for the board to establish and make available a diversity policy (presumably because this is part of DTR 7.2.8A). As a result, the third bullet point in (new) Provision 24 calls for the effectiveness of the policy to be reported on by the nomination committee, notwithstanding the fact that there is no Provision requiring it to be created. In situations like this, we consider that it would be preferable to allow possible duplication to make for a complete framework in the Code, and with an explanation of where duplication exists and one piece of reporting can therefore cover both requirements.
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?

Yes - the language added to (new) Principle I (including references to equal opportunities, and protected and non-protected characteristics) better reflects the technical and legal framework in this area.
Q8: Do you support the changes to Provision 24 and do they offer a transparent approach to reporting on succession planning and senior appointments? Whilst we support the changes to (new) Provision 24 in general, we note that, on a point of detail, the phrase "*in order to deliver the company's strategy*" in the first bullet of (new) Provision 24 is neither necessary nor clear in its intention. More generally, although there are various references to both a succession plan and a diversity and inclusion plan, it is not stated what form these are expected to take. Previous FRC publications have called for these to be formal written documents and, if that remains the expectation, it would be helpful for the Code to specify this.
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? It is not possible to comment fully on how the relevant aspects of the CGI recommendations have been incorporated without the accompanying guidance. We are not wholly convinced that the term '*board performance review*' is any more forward-looking than a '*board evaluation*', and would suggest a phrase such as '*board effectiveness assessment*' might be more appropriate if it is felt a change is necessary. (New) Provision 22: An external board performance review is called for at least every three years for FTSE 350 companies. This is not new, but there has never been any guidance as to what is expected when a company joins the FTSE 350. If a company has never had such a review, we question whether it is appropriate that it should wait for three years before undertaking one. Guidance would be helpful here, and could, for example, recommend that an external review is considered as soon as possible after a company joins the FTSE 350, particularly where there has not been a review previously. The updated draft Code (new) Provision 22 continues to refer to 'FTSE 350 companies' as opposed to using the 'small company' definition set out in Footnote 10 to the Code. This is significant because the small company definition contains 'smoothing provisions' that otherwise do not apply, and it seems to introduce unnecessary complexity to the overall framework. We do not have any issue with extending the expectation of an internally-facilitated review to all companies applying the Code, but it is important that the guidance makes it clear that for non-FTSE 350 companies this could be less frequent than the three year intervals recommended for FTSE 350 companies.
Section 4 – Audit, risk and internal control
Q10: Do you agree that all Code companies should prepare an Audit and Assurance Policy, on a 'comply or explain' basis? We agree that all Code companies should prepare an Audit and Assurance Policy (AAP) on a 'comply and explain' basis, as we fully support the AAP and its objectives and consider that it is important that it applies to this wider population. If it is not included in the Code, only a small proportion of listed companies will be required to prepare an AAP (compared with over twice as many private companies). However, we consider that clarification is needed about how the FRC envisages 'comply or explain' under the Listing Rules/Code, will apply to multi-requirement standards or statements that are external to the Code (as opposed to specific Provisions in the Code) like the AAP and minimum standard for audit committees discussed below. We also agree that it makes sense for the audit committee to "own" the AAP, although this shouldn't absolve the full board of its overall responsibility.

We note that the statutory instrument introducing the AAP (the Companies (Strategic Report and Directors' Report) (Amendment) Regulations 2023) will, once made, be applicable both to companies that exceed 750 employees and £750m annual turnover "the 750/750 threshold"), and potentially UK groups, if the aggregated results of at group exceed this threshold and consolidated accounts are filed. For Code companies that are not required to have an AAP under the statutory instrument, but are preparing one in compliance with the Code, where that company is a parent company that prepares consolidated UK accounts, it should be clear that a consolidated AAP should be prepared, to be consistent with the group focus of all other aspects of the Code.

We agree with paragraph 40 of the Consultation that there should be greater engagement with shareholders on various aspects of the audit committee's responsibilities. This will be particularly important for the AAP as, in our view, it will help audit committees to determine what information from the annual report is most important to users, which should then be included in the AAP. Engagement with shareholders will also be important to help audit committees determine if sufficient assurance has been obtained. With regard to engaging with other stakeholders, in our view this could be helpful, for example with banks and employees etc, but there will need to be guidance or parameters about which stakeholders the company should engage with, the nature of that engagement, and the expected level of engagement. Audit committees will need to have a process in place to deal with comments and requests made by shareholders and other stakeholders, in particular, in regard to the AAP and the scope of the external audit.

We also suggest that the Material Fraud Statement, which is being introduced into law by the Government through the statutory instrument noted above, for companies over the 750/750 threshold, should also be included in the Code on a comply or explain basis. This statement is equally important as the AAP and Resilience Statement, and it would seem incongruous not to include it, especially given the desire to simplify requirements as much as possible. Also, given the attention that is being given in the market to the "failure to prevent fraud" offence included in the Economic Crime and Corporate Transparency Bill, this is an area that we expect will be focused on by stakeholders, and so it would seem important for all Code companies to be asked to make the Material Fraud Statement.

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?

We support expanding the scope of the minimum standard beyond the FTSE 350 in this way, as it supports the important role the audit committee plays in the audit market and in ensuring audit quality.

We agree that this is an effective way to remove duplication. However, as noted in our response to Q6, we would err on the side of duplication where this allows for a more complete and coherent framework in the Code. Notwithstanding this, if the intention is not to have duplication, the seventh and eighth bullet points in (new) Provision 26 appear to cross over with the first and eighth bullet points of paragraph 4 of the minimum standard for audit committees respectively (on promoting audit market competition and developing a non-audit services policy).

It will also need to be clear in the Code, or the proposed accompanying guidance, that companies are expected to follow the full minimum standard so that important requirements, such as describing the significant issues considered by the audit committee, are not lost in the cross-referring. With that in mind, as noted above, clarification is needed about how the FRC envisages 'comply or explain' under the Listing Rules/Code will apply to multi-requirement standards or statements that are external to the Code (as opposed to specific Provisions in the Code) like the minimum standard for audit committees and AAP, described above.

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 agree with the expansion of the remit of the audit committee in this important area - many already have narrative reporting under their terms of reference. That said, sustainability issues, including ESG metrics, are sometimes of strategic significance, or sometimes included mainly in connection with a company's commitment to the government's sustainability plans, for instance, or other social purposes. In the case of the second category, reporting might not be of sufficient financial importance to mean it needs to be dealt with by

the audit committee, but having this area under the remit of the audit committee in the first place will allow it to determine what does, and does not, need its attention.

In order to link the different elements, we suggest that in (new) Provision 27, the following bullet be amended to refer to the AAP (suggested text underlined):

"*Where commissioned by the board, the assurance of environmental, social and governance metrics and other sustainability matters (this description could be part of the AAP where one has been prepared)*".

However, we do have concerns that reference to "*narrative reporting*" in (new) Provisions 26 and 27 implies reporting that does not include metrics, so we suggest instead "*other information provided with the financial statements*" to be a clearer and more encompassing term.

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

We support having a stronger declaration about operating effectiveness of internal controls, with an explanation of the basis for that declaration. However, in our view, the main challenge with this approach is whether it will be sufficient to drive the desired change in behaviour by those companies that have not been demonstrating good practice in risk management and internal control to date.

In our experience, change is definitely needed as there is significant diversity in how companies address the current Code Provisions in these areas. The confusion we are hearing from companies about how much they will need to do to support the stronger declaration emphasises the widely different approaches companies currently take and, therefore, their starting points for change.

We have outlined below the elements that we think are essential to ensure the changes are successful.

Guidance
We understand that the FRC prefers not to give prescriptive guidance, and that an approach to risk management and internal control should be tailored to the facts and circumstances of the individual company. However, this has resulted in very different approaches (and hence different degrees of robustness) to these Provisions in the Code currently. A stronger declaration will go a long way towards ensuring companies develop a more robust approach, but only if boards have greater clarity as to what is expected of them, and confidence that there will be a degree of consistency and comparability across the market. We are hearing directly from many organisations that they want greater certainty, not less, about what needs to be considered in order to achieve effective risk management and internal control systems. The FRC needs to provide a "vision" about what good looks like.

The Code is a principles-based, comply or explain structure, but this does not prevent the accompanying guidance from being detailed and specific. The guidance could build on what is in the existing guidance, as this is generally well regarded, if underused, but it will need to be more specific if it is to give boards the comfort they need that they are doing the right thing to support their declaration. Any guidance also needs to be much more widely used than is the case today. As we mention below, having the guidance as an appendix to the Code could help enormously in raising its profile.

The power of the guidance will also depend on how it is promoted and used. As we have suggested above, the guidance in this area could be included as an appendix to the Code itself to emphasise its intrinsic importance and make sure that the link with the Code is maintained. More explicit and direct links should also be made between the Code requirements and the relevant parts of the guidance. In the current version it is not always immediately obvious to a user when and how to apply the advice that it contains. This link will be especially important if the guidance is not included as an appendix to the Code.

In our view, the guidance, or indeed the Code itself, should include the following, at a minimum.

- *An explanation of what is meant by "review and monitor" and what the FRC expects these activities to entail.* As this is the same language that is currently in the Code, there is a danger that companies will not improve on their existing approach, which will not achieve the desired outcome from the

revised Code. Either stronger terminology is needed and/or the guidance must be clear what is expected as part of this monitoring and review process. It would be especially helpful to have worked examples or FAQs that could provide practical guidance on how often review and monitoring should ideally happen, who would normally be involved, the types of evidence that would be needed and suggestions for an independent testing programme.

- *What companies should consider when identifying material controls*. Whilst we accept that this could be down to individual judgement, material controls are presumably those that would address material risks to the business, and those risks are very often complex and multi-layered, which can result in many controls addressing multiple aspects of the risk. In some cases no single control could prevent a material issue, and a combination of controls will be needed. To ensure a targeted and proportionate approach the guidance could describe the factors that should be considered when assessing materiality, so that companies go through a consistent thought process and are properly focused on material controls, especially in the operational and compliance areas, as controls in these areas could be numerous if the right parameters are not set.
- *How companies determine the nature and value of controls.* Arguably a strong entity level control, carried out with sufficient regularity, precision and independence could mitigate more of a material risk than an individual transactional level control.
- *An example of a material weakness of failure.* Examples would be helpful, especially in the context of operational and compliance controls. The suggested definition includes quite subjective language (for example, “reasonable possibility”, "adversely affected”) and there is a risk that this could be interpreted in such a way that that reporting of material failures/weaknesses is so judgemental that it is largely non-existent.
- *How companies should identify the framework they should use.* Guidance as to whether this will need to be a formal framework, such as COSO, or whether it could be one that has been internally developed would be helpful. That said, if the latter, this could cause issues with comparability between companies and also may prove challenging if formal assurance of the effectiveness of internal controls was ever to be requested by the company or investors.
- *The documentation and evidence that is expected to support the declaration.* We believe there is a role for some degree of self-certification in support of the declaration, as long as it is based on substantive evidence that the controls have operated effectively. A cyclical independent testing programme, for example by internal audit, would also strengthen any self review or certification, but will need strong documentation and evidence of controls operation.

Other points we would note are:

- (New) Provision 26 of the revised Code states that the audit committee has responsibility for reviewing risk management and internal control but the board in (new) Provision 30 reviews and monitors. We suggest the audit committee’s responsibilities should also include review and monitor, although, as we note above, we believe this overall responsibility needs strengthening.
- Paragraph 59 of the Consultation states that (new) Provision 30 of the revised Code will be amended to set out expectations about the evidence gathered by the company in support of its reporting, but evidence is not mentioned in (new) Provision 30. We suggest that (new) Provision 30 is amended to say (suggested additional text in bold) “*An explanation of the basis for its declaration, including how it has monitored and reviewed the effectiveness of these systems,* ***and what evidence it has obtained to support its declaration***”
- Presumably (new) Provision 30 will also continue to be one of the Provisions of the Code that auditors are required to ‘review’ under the Listing Rules. The FRC’s guidance on this has not been updated for many years and this should be addressed urgently as part of the overall update.

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?

More clarity is needed about what the FRC envisages the board declaration should entail, including what is meant by “*continuous monitoring*”, and whether this is expected at the board level or at a level below (i.e. management). Presumably this will be addressed in the planned guidance and we therefore need that guidance in order to comment fully. Notwithstanding this, we do have a concern that an expectation of a “continuous” monitoring process could, for many companies, result in a light touch approach. Instead, regular

periodic assessments (perhaps every quarter or every month - in line with the operation of the material controls), could be more practical and would enable a more robust, in depth assessment. As noted above, maintaining evidence of control operation will be essential.

In our view, the effective date of the declaration should be the year end rather than the date the annual report is approved. This would better reflect how companies operate, and the governance and processes that need to be in place to support what will be an important statement. This would be aligned with other statements made in the annual report. There could be some additional, lighter "stand back" procedures suggested to keep the review current up to the date the annual report is signed, without the full review needing to be at that date.

Notwithstanding our comments above on the date of the declaration, consideration should also be given to the use of the term "*date of the annual report*". We believe, from reading the Consultation, that this is intended to mean the date the annual report is signed, which can be a number of months after the year end. However, this might be interpreted by some as the balance sheet date. Clarity is also needed as to whether this means that the review and monitoring responsibilities for Q1 of the following year also fall within the scope of the declaration.

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 agree with expanding the scope to include non-financial reporting controls. This is an ever increasing area of importance for companies, investors and other stakeholders. We are aware of the debate about the proposal to have the declaration in (new) Provision 30 cover all areas of internal control (operational, reporting and compliance) and not just internal control over financial reporting (ICFR). Again, this is largely not new and to switch to ICFR only would be a major reduction in what is expected of boards under the existing framework.

However, in our view, there is a broader scoping consideration. The draft of (new) Provision 30 limits the scope of the board to "material controls", so this term needs to be understood in relation not only to financial matters but also the other aspects of risk and control. Again, it will be important for the guidance to address this. We note from the indications on page 21 of the Consultation of what the guidance will cover, that the proposed definition of a "material weakness" is expressed in terms of what will affect a company's ability to achieve its strategic, operational, reporting and compliance objectives, and we recommend that this is developed as a basis for materiality judgements generally in the final guidance. As part of this discussion, we believe it would be helpful to point out that strategic objectives are usually the key driver - the other objectives largely 'enable' the strategy to be delivered. This is also another reason why a focus only on ICFR would be too narrow to achieve the purpose of the Code changes.

As we indicate in our covering letter, the AAP would be a logical framework for scoping what is focused on in the internal controls assessment, and we recommend that it is referenced as such in the guidance. The AAP is focused on reported information in the annual report, and in our view, will be a valuable way to identify the most important financial and non-financial reporting. For most companies, we envisage that the AAP will also include the principal operational and compliance risks that face the company, as described in the annual report, as well as risks to resilience in the Resilience Statement and fraud risks in the Material Fraud Statement. Using the AAP as the framework to identify these areas, and mapping the related key controls and other 'lines of defence', will bring structure and manageability to the scoping process. It will also bring together many of the different aspects of the reforms in one place, and help ensure that they work as a package.

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 control systems?

In our view, companies need to be encouraged to use a formal framework, otherwise there is a risk that there will be a lack of consistency and comparability across the market, and it may be more difficult to obtain external assurance should companies choose to seek that under the AAP. As part of the basis for their declaration, it will be important that companies describe the framework used, which should be robust and, ideally, recognisable. A reference to a framework such as COSO (which is itself scaleable) could easily be integrated into the guidance as an option (although boilerplate references to COSO should be avoided). One

other point of reference, as noted above, could be the AAP. This would help companies scope their material controls for their assessment, but there would then need to be further guidance about what the operating effectiveness of these controls should be measured against.
Q17: Do you have any proposals regarding the definitional issues, e.g. what constitutes an effective risk management and internal control system or a material weakness? Paragraph 70 of the Consultation proposes that the definition of a material weakness could be "*A fault, deficiency or failure in the design or operation of the risk management and internal control framework, such that there is a reasonable possibility that the company's ability to identify, assess, respond to or monitor risks to its strategic, operational, reporting and compliance objectives is adversely affected*". As noted above, there is significant scope for interpretation in this definition, and it is possible that companies could argue that a matter is not a material failure to such an extent that material weaknesses or failures are never disclosed. Also, this definition refers to the design of risk management and internal control systems as well as their operation, which we agree is equally, if not more, important as operational effectiveness will be irrelevant if a control is badly designed. However, as the actual declaration in (new) Provision 30 refers only to effectiveness, we suggest that there is reference to "design" and "operational" effectiveness for the avoidance of doubt. Following on from this part of paragraph 70, it also says the board will determine what is a material failure using its "*professional judgement*". The guidance will need to be clear about how the board is expected to make this judgement and what experience it will be based on. Examples would be helpful.
Q18: Are there any other areas in relation to risk management and internal controls which you would like to see covered in guidance? See our response to Question 13.
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)? Our preference would be for going concern reporting to be integrated with the assessment of prospects in (new) Provision 32, in a similar way to that proposed under the Resilience Statement. 'Standalone' going concern reporting currently varies significantly in its usefulness and, where there is a material uncertainty, tends to duplicate, or has the potential to cause confusion with, the disclosures in the notes to the financial statements.
Q20: Do you agree that all Code companies should continue to report on their future prospects? We agree that all Code companies should continue to report on their future prospects. However, as it stands, the (new) Provision 32 and footnote 14 together, appear to call for a version of the Viability Statement "*in a similar and proportionate way to the requirements of*" the Resilience Statement, which is not sufficiently clear and could result in some Code companies having a Resilience Statement, and others having a Viability Statement. We suggest that Code companies should be required to adopt the Resilience Statement on a comply or explain basis, in the same way the AAP has been included in the Code as this would be a much clearer and more consistent approach. It would also be preferable to adapting the 'Viability Statement', as this lost some credibility following the Brydon review and the subsequent consultation on '*Restoring trust in audit and corporate governance*'.
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?

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See our response to Q20

Section 5 – Remuneration

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

We wholeheartedly support changes that promote a stronger link between remuneration and corporate performance. While the need for such a link is widely acknowledged - and practised - by the majority of listed companies, meaning that radical changes are not needed, we support making it more explicit in the Principles.

We set out specific comments in relation to malus and clawback, changes to (new) Provision 40/41, and the reference to pay gaps and ratios under Questions 23-25 below.

We also make the following observations:

- **Principle P:** Many companies, shareholders and other stakeholders are likely to welcome the explicit reference to alignment with ESG objectives, given the importance of this area and growing prevalence and focus in executive pay. We note, and support, that this does not require companies to link remuneration outcomes directly to particular ESG targets, thereby retaining flexibility for companies to design remuneration schemes appropriate for their business.
- **Principle Q:** This formalises the remuneration committee's consideration of workforce pay and conditions as an explicit expectation, although we note that the vast majority of remuneration committees consider this on a regular basis already.
- **Provision 34:** The current proposed wording implies that the remuneration policy would "*identify and mitigate risks…*" and "...*ensure outcomes are proportionate*…". In practice, such identification, mitigation etc. is the responsibility of the remuneration committee and, therefore, a more appropriate version of this may be *"In designing the remuneration policy and overseeing its implementation, the remuneration committee should identify and mitigate risks associated with remuneration and ensure that outcomes are proportionate and do not reward poor performance."*

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

In our view, the proposed changes relating to malus and clawback are helpful. We make the following observations in relation to the proposals:

- Although (new) Provision 39 refers to directors, it is not clear whether the disclosure under (new) Provision 40 is required only in relation to directors or whether the use of malus/clawback for any participant (including below board roles) is required. Assuming it is intended to relate only to directors, the FRC may wish to consider whether this should also include former directors.
- The phrase "*minimum circumstances*" may be misunderstood as implying that additional circumstances may trigger malus and clawback - the scenarios that may trigger malus and clawback are typically set out in plan rules or other award documentation and consequently it is not usually possible to enact malus or clawback in additional scenarios outside of this list. The FRC may wish to instead consider requiring disclosure of *"the circumstances in which malus and clawback may apply".*
- The phrase "minimum period" may not be relevant to all companies because:
    - the end of the period over which malus may be applied is generally the vesting date (and after this point, clawback would need to be enacted so there is no longer period for malus); and
    - companies typically specify a maximum period (e.g. two years) for clawback after the vesting date, rather than a minimum period (although some companies include a provision

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to extend this period, for example where an investigation is ongoing). The FRC may wish to instead consider requiring disclosure of *"the period over which incentives may be subject to withholding or recovery".*

- The length of the clawback period should be commensurate with the tail risk profile of the company's business - for example, this can be long term for mortgage lenders and under CRD V the clawback period can be up to ten years (although it may be difficult to articulate precisely why ten years is appropriate). Conversely, the tail risk profile for FMCG businesses may be much shorter (e.g. one year). Nevertheless, in practice, we observe that the vast majority of companies (excluding financial services) operate a two year clawback period post-vesting.
- It is not clear what the intended difference is between the requirement to disclose the use of the provisions in the last reporting period and in the last five years. For example, it is not clear whether the FRC expects that companies provide more granular detail in respect of the last reporting period and state how many times the provisions have been used in the last five years. We note that there is a placeholder footnote that will reference a template in the accompanying guidance, and this may therefore make the distinction clear.
- In addition to disclosure of a clear explanation for the reason for enacting malus and/or clawback, a more comprehensive view of the use of the provisions may be formed if the following are also discussed: i) the amount withheld or recovered, ii) how the amount was calculated and iii) to which original award it relates.

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

The proposed removal of Provision 40 and associated disclosure requirement under (new) Provision 41 is reasonable, as disclosures appeared largely similar between companies. However, it is important that any revisions are a response to practical challenges with the implementation of the current Code, rather than a lowering of overall standards and corporate governance practices.

We believe that companies struggle to provide tailored disclosure against some or all of the factors under Provision 40 for the following reasons.

- The factors listed in Provision 40 are high-level and would be considered by most remuneration committees as part of the normal process. Nevertheless, the high degree of homogeneity amongst UK executive pay schemes means that many of the factors are addressed in similar ways, which may contribute to the perception of boilerplate disclosure. For example, most UK companies have the same bonus + three year LTIP incentive structure and, therefore, the simplicity of the structure of their remuneration package is largely the same. Similarly most companies operate malus and clawback provisions, which demonstrates consideration of the risk factor.
- Some of the factors replicate existing disclosure requirements for quoted companies. For example, the predictability factor - the reporting regulations require a scenario chart of remuneration outcomes to be presented when seeking approval for a new policy and it is a regulatory requirement to specify the remuneration opportunities and areas of discretion within the policy.
- Some companies were not clear on the FRC's expectations in respect of certain factors - for example, under the clarity factor, it is not clear how the remuneration arrangements themselves can promote effective engagement with the workforce.

The incorporation of some of the key factors into the (new) Provision 34 will encourage remuneration committees to remain mindful of these factors without the requirement to provide annual disclosure on how the policy meets them (particularly given that most policies remain unchanged for three years). The FRC may consider if companies should disclose whether this has been reviewed during the year in light of sufficient changes in circumstances.

We also recognise that not every company reporting against the Code is required to comply with UK disclosure requirements for quoted companies (or does so voluntarily) - it may be useful for those that do not to be reminded of these issues.

In respect of the other proposed changes to Provision 41 (now Provision 43).

- A strong link between company strategy (including ESG objectives) and executive pay policy and practices is vital, although we note that similar requirements already exist under the reporting regulations (for example SI 2008/410, Schedule 8, Part 4, Paragraph 26(a) and Paragraph 27(a)). Nevertheless, under the proposed wording, it is unclear that the "*strategic rationale*" for policies, structures and metrics would support company strategy and ESG objectives. The FRC may instead consider aligning this wording more closely with the proposed wording under (new) Principle P - for example *"an explanation of how executive directors' remuneration is aligned with the company's strategy and environmental, social and governance objectives".*
- It is not clear what the FRC's intention is under the requirement to explain "*whether the remuneration policy operated as intended",* and in our experience this often attracts simple factual statements. As remuneration policies typically provide remuneration committees with the ability to override formulaic outcomes (upwards or downwards), it is difficult to envisage a scenario where the policy would not have operated as intended, even if the formulaic outcome was deemed to be inappropriate. In our view, this requirement does not encourage meaningful disclosure from companies.
- Companies are likely to welcome the removal of the expectation that they engage with the workforce specifically to explain the alignment of executive pay with wider workforce remuneration policy, and instead focus on the impact of engagement (for example on remuneration more generally) on remuneration policy, including the alignment with overall company pay policy.

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

At its heart, this Provision relates to how companies consider fairness when setting pay. In some aspects (e.g. equal pay, minimum wage) there are clearly statutory requirements but our view in general is that this is an area in which companies should define what fairness means for them in the context of their business, and report against it. In our experience, companies use a range of internal and external reference points when considering executive pay, including internal relative measures such as pay gaps and pay ratios but these may not always be the most useful and other metrics may be more so.

Whilst the CEO pay ratio is one possible internal measure, providing context to year-on-year movements in pay and the absolute level, it is limited to the three quartile reference points and there is generally limited comparability between the CEO and the sampled roles. We note that the CEO pay ratio disclosure requirements already require in-scope companies to explain whether the median pay ratio is appropriate and why.

Another external measure is benchmarking data. In practice, very few companies use this in isolation (although disclosure could make this clearer). Instead, such data is typically considered in combination with other reference points, such as pay relativity to direct reports, international benchmarking data and wider workforce salary increases.

We therefore believe that including a reference to the appropriateness of pay and internal/external measures (without specifying these further) may be helpful. For example "*how the remuneration committee is satisfied that executive remuneration is fair and appropriate, including details of any internal and/or external measures used in making this assessment*".

Other matters for consideration

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?

As we noted in our response to the Government's White Paper, the importance of risk and governance stretches across the AI lifecycle, from inception through design, development, and deployment to maintenance and robust risk assessment, and governance frameworks at a granular level will be helpful to allow many businesses, particularly SMEs, to utilise and innovate with AI technology with confidence.

Also as noted in our response, we agree that disclosing the use of AI is the crucial first step towards achieving greater transparency. By requiring disclosure, greater trust can be established for users of AI systems. Furthermore, disclosure serves as a means to protect consumers' rights by providing them with essential information for making informed decisions and determining whether they wish to engage with an AI system or not. Additionally, disclosure requirements create a necessary foundation for allowing users to contest the outcomes of AI decisions and, if applicable, seek compensation for any harm caused by such decisions. To ensure that disclosure has a positive impact on transparency, businesses should develop robust AI governance practices. These practices should include inventories of their AI systems, information on their origin (whether in-house built or from third parties), accountability mechanisms, documentation processes, and risk management procedures. Also, in order for organisations to innovate with confidence within the boundaries of the Government's proposed framework, we believe that it is important to make clear guidelines available on the internal governance, risks and controls that businesses may need to adopt.

It would seem sensible that consideration of all of these governance-related areas are factored into the Code or that they are included in the updated guidance.

We would be happy to share our full response to the Government's White Paper with the FRC if it would be helpful.