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Dear Chair

**RESPONSE FROM INDEPENDENT AUDIT LIMITED TO THE FRC CONSULTATION ON THE PROPOSED CHANGES TO THE CORPORATE GOVERNANCE CODE**

Independent Audit Limited is a consultancy which specialises in reviewing board effectiveness in both listed and non-listed companies. Our clients vary considerably in size and maturity of governance development. Much of our work involves identifying opportunities for boards of directors and their committees to work more effectively. We have been undertaking such work for more than 20 years, involving a team of some fifteen consultants.

We also undertake work to review the effectiveness of the governance framework, risk governance, the external audit process and internal audit.

In this response, we address the questions which are most immediately relevant to our work.

**SECTION 1**

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

Yes, we agree. Change is often driven through reporting requirements.

We have some concerns, however, that the term “governance practices” is very broad. “Governance” includes a lot of activity and processes that a board is not directly involved in (such as shareholder registration, voting processes etc). Governance also happens at executive level and, through governance systems such as audit and compliance, throughout the company. This term in Principle D needs to be defined more closely, for example as “board governance”. Also, guidance will be needed as to the type of governance activity/practices that need to be covered.

**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?**

Yes, this would be beneficial as change is often driven through reporting requirements.

We find it difficult to understand why “committee chairs should seek engagement with shareholders” has been changed to “committee chairs should engage...”, particularly as the “seek” has been retained in the previous sentence as regards the board chair. Not all shareholders are enthusiastic about engagement with all committee chairs and consequently there will be times when “seeking” is all the chairs are able to do.

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

Again we see this as beneficial as reporting drives change.

However, the wording could be made more realistic. A board cannot measure how far the desired culture has been embedded, especially in such an intangible area. There will be a few indicative measures, but culture does not lend itself to measurement. This could be reworded to “report on the steps the Board has taken to help ensure that the desired culture has been embedded and to form a view on this”.

**SECTION 2**

**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?**

We agree that each director’s commitments should form part of internal reviews.

We do not agree that this should be a required part of external, independent reviews. It should be for the Chair and Nominations Committee to do the necessary research and make the required judgement and not the Reviewer, who inevitably has only a partial view of a complicated set of factors and of the individual(s) involved. The ability to discharge responsibilities is not static and needs periodic review by the organisation. That is the Chair’s job and partially-informed comments from an external review are likely to be unhelpful, possibly damaging. It may also leave the Reviewer exposed to criticism from directors in a way which undermines the rest of the Review report.

A Reviewer should comment on the skills mix. But they should not comment on individual appointments except in more extreme cases (in which cases the comments should be given directly to the Chair and/or Nominations Committee Chair and not be included in the report).

Giving the issue more prominence as part of evaluation discussion by the Board will help bring focus to the question. But invariably it will be highly personal, so it is not evident that it can realistically form part of a board discussion. Such discussions are better left to the Nominations Committee and the Chair.

**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?**

No. This is impractical as it is highly dependent on the detail regarding, for example, the roles, timing and nature of the organisation where the Director sits on the Board. Moreover, a Director’s capacity is also affected by other important factors such as personal stamina and commitments at home. Any description in an Annual Report is likely to be vague and subjective, and subject to interpretation based on insufficient information. It should be the Chair and Board who make this judgement and then explain in the Annual Report how the question has been addressed.

The proposed style of reporting would not increase transparency particularly as the detail has to be set out. The decision should be a question of board judgement: investors trust boards in many other ways and so they should do likewise on this.

### **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?**

Yes.

**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 agree. But the text should acknowledge that there will sometimes appear to be conflict between “based on merit and objective criteria” and “diversity and inclusion of protected characteristics and non-protected characteristics including cognitive and personal strengths”. It is already the case that emphasis on merit and objective criteria can be used as a convenient excuse for making only a modest effort to achieve diversity. This should be addressed in a way that makes it more likely the diversity objectives will be properly taken into account. It would also be helpful if plainer language could be introduced. It is not clear that “protected” and “non-protected” characteristics is widely-understood language.

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

In general, yes. Reporting by Nomination Committee is in need of development and has not yet progressed in the way that reporting by Audit Committees has advanced.

Such reporting will contribute to a transparent approach but it should be recognised that confidentiality considerations will limit the extent to which the reporting can be open.

It is not clear to us why reporting on the board performance review should be a prescribed component of the Nomination Committee report, as opposed to some other part of the governance reporting. This section of the Code places emphasis on aspects of a board performance review that are relevant to the Nomination Committee, but a good board review will consider many other aspects that do not fall naturally within its remit.

**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?**

Yes. We support the adoption of “board performance review” and use of the word “performance”.

Yes. We support the change to the Chair commissioning a review rather than considering.

We are supportive of the CGI Guidance and its forming part of Code guidance.

## **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 in general terms with the intended approach to the preparation of an Audit and Assurance Policy.

The revised wording of (new) Principle N is not clear enough, as it seems to suggest that the Board has direct responsibility for the risk management and control systems. It is generally understood that this is a management responsibility in the first instance, and the Board's duty is to exercise oversight of management in this regard.

Provision 26 sets out main roles and responsibilities of the audit committee, one of which is "promoting effective competition during the tendering for an external auditor, to support audit market diversity". Audit market diversity is a laudable public policy objective but audit committees require clarity over the appropriate order of priorities where it appears to compromise their objectives regarding audit quality, quality of service and value for money.

### **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?**

Yes.

### **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?**

In principle, we agree that the responsibilities of the Board should include approval of narrative reporting and that the detailed work of oversight be delegated to a board committee. It is not, however, automatically the case that all narrative reporting should be delegated to the audit committee. Such delegation might appear logical but it creates many practical issues which would be better left to individual boards to resolve.

We suggest that the Code confirm the responsibilities of the board for ensuring the quality of narrative reporting, but allow each board to work out how this should be covered by its various committees (which increasingly include committees dedicated to ESG/Sustainability and other areas relevant to narrative reporting). The Code could then require boards to explain how their oversight in this area works and the activities of the committee(s) in this area of oversight.

If the current wording were to stand, the implications of such delegation to audit committees, in terms of their workload and technical expertise, would need careful consideration. In particular, the expertise angle should be considered: while audit committees have the conceptual framework and assurance approach, a different type of expertise will be required to judge narrative and sustainability measures/standards/controls/assurance etc. This requirement would need to be referred to explicitly in Provision 25, which currently only explicitly refers to financial experience.

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

The question is broad and difficult to interpret. We refer to our previous comments on practicality and responsibility. It seems to be putting too much onus on the board whereas execution responsibility has to sit with the executive structures.

The change in wording of Provision 26 (9<sup>th</sup> bullet) to widen the scope behind financial controls is logical. However, there does not seem to be sufficient reason to delete reference to financial controls in Provision 30.

The emphasis on review and effectiveness review in the Code is sound. But “effectiveness” goes beyond structures and processes: the practical impact is what ultimately matters. So the Code or the Guidance should refer to “impact” as well as “systems”.

Also “systems” needs to be understood to include culture and informal controls such as operational management.

Provision 30 introduces a major change requiring the board to make a declaration. It is not clear that what is required is achievable. Also it is not clear that requiring a declaration will achieve much more than requiring improved reporting on how the board goes about assessing the effectiveness of risk management and internal control. There are numerous considerations, including:

- For the Board to arrive at the required conclusion implies that directors (especially non-executive directors – “NEDs”) have more insight and authority than in practice is the case. Or possibly a level which cannot be achieved without straying into executive territory.
- A Board has to rely on executive governance and control structures. So this provision might result in the need for Reporting Committees (as followed in the case of Sarbanes-Oxley) and executive certification. The potential consequences should be considered.
- It is not possible to state that the systems have been effective without some sort of widely accepted definition of what “effective” means in this context.
- Even with an adequate definition of effectiveness, it is not possible to state that the systems have been effective throughout the period and up to the date of the annual report without introducing real-time monitoring systems. This is probably impracticable and may very probably be impossible to implement within the period between now and the first annual report under this regime. It would also be expensive and the value-for-money case has not been established.
- Risk/organisational culture is a vital part of risk management and internal control. It is difficult for a Board to conclude that this has been effective in the recent past, as some consequences of ineffectiveness will not be apparent for some time.
- More generally, reference to the company’s risk management and internal control systems does not make it clear that it includes the overall control environment, which is a crucial element.
- Guidance will need to draw out the distinction between the effectiveness of risk management and internal control structures and processes, and the impact that these have. The impact is the critical issue.
- It will be unrealistic for boards to report on material weaknesses and failures given commercial sensitivities and in the absence of a definition of “material”. Boilerplate, selective reporting is likely to result.

**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 repeat the point we made in Question 13. The requirement would need to be underpinned by a level of real-time monitoring that, for many companies, will be unrealistic and most likely unjustifiable from a cost perspective.

**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?**

Yes – but as a statement of intent only. Financial reporting is numbers-based, and systems producing numbers can be subject to specific controls in ways that are well understood. Some narrative reporting is qualitative in nature and does not lend itself to being looked at in the same sort of way.

It may be necessary to limit “reporting controls” to statements including quantification or which imply a verifiable quantification (eg “x grew”; “y declined”). This would not be straightforward but it would possibly be more achievable than bringing all narrative reporting within the same framework of assessment.

**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?**

This will be important if any progress is to be made in avoiding the widespread practice of equating “effectiveness” to having recognisable structures and processes in place (as opposed to also looking at the impact).

**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?**

This is a complex question. Effectiveness and material weakness are both extremely context-specific, but no meaningful reporting can be expected if there is no definition. It can possibly best be answered through companies being required to set out their own definition, but that risks so much variation that the reporting ceases to be meaningful. Examples and guidance will be needed to set a framework within which companies can report.

We repeat our view that it is important to emphasise the impact of risk management and internal controls. That is, how risk management and internal control leads to better decision-making and rigorous application of policies, process controls, limits, exposure management etc. In simple terms, how risk management and internal control actually affect the way the organisation is run. This is the crux of effectiveness, not just having risk management and internal control structures which look as though they should be effective.

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

The vital importance of maintaining a sound risk culture does not come through in the Code wording. It therefore needs a heavy emphasis in the Guidance. This should include forceful encouragement to Boards and the relevant board committee to develop structured approaches to assessing management’s approach to developing and embedding the target risk culture.

**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**

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**reporting on prospects in the next Provision, and to achieve consistency across the Code for all companies (not just PIEs)?**

Yes.

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

Yes.

**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.

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

Yes.

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

Yes.

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

Yes.

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

The reference should be strengthened along the lines described in the Consultation document.

**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**

Not at this time.

Yours Sincerely,



Richard Sheath

Director