Financial Reporting Council
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Emailed to: codereview@frc.org.uk

13 September 2023

Dear David Styles,

Re: UK Corporate Governance Code Consultation

This letter is written by the 100 Group Main Committee and is intended to speak on behalf of the Group as a whole. The 100 Group of Finance Directors represents the views of the finance directors of FTSE 100 and several large UK private companies. Our aim is to contribute positively to the development of UK and international policy and practice on matters that affect our businesses.

We believe that a foundation of the strength and resilience of British business is the leading governance framework that we operate under in the UK.

We see the implementation of the recommendations from the recent BEIS consultation 'Restoring trust in audit and corporate governance' as a great opportunity for differentiation when focussed on the areas of priority as identified by Kingman, Brydon, and the CMA, and we are pleased that efforts are being made to implement recommendations in a number of areas.

In responding to this proposal in particular, we would like to note that the views expressed are informed by the plural roles that many of our members perform – as well as leading the finance function for FTSE100 companies, many of our members sit as non-executive directors, often as Committee Chairs, for similar sized businesses. However, in seeking to speak on behalf of the membership as a whole, our final position is necessarily focussed on the perspective of the finance leads. Finally, we note that whilst this letter expresses the views of The 100 Group of Finance Directors as a whole, these are not necessarily those of our individual members nor their respective employers.

Response

Overall, while we are pleased to see a new version of the code in response to the long running corporate governance reform program, we are disappointed that much of what has been communicated in response to previous consultations has been overlooked.

We have addressed each of the individual questions posed in the consultation, and as part of this process we identified the following key themes which run through our commentary and which we consider significant enough to warrant being called out.

Definitions and guidance

There is ambiguity in the current drafting due to a lack of clear definitions and guidance. We appreciate that guidance will follow but to form any detailed response to such alternative proposals without any written guidance is problematic, in particular where we have a diverse membership who have often interpreted matters quite differently. As well as guidance, definitions will need to be provided for undefined descriptors such as 'narrative reporting', 'Materiality'; etc.

Scope and Timing

As we said upfront we are glad to see an output from the long running reform project and support the quick implementation of any such outcomes but the timing must be considered within the context of what is being asked which in turn is dependent on the guidance to be issued. As an example, the controls reporting requirement as we currently understand it would be a significant task even for those of us relatively well advanced along the ESG journey and with relatively more available resource (time; technology; and process).

It is also important to be clear on the interaction between the Corporate Governance Code and other pre-existing and new Corporate reporting obligations – in particular in respect of the Audit & Assurance policy and the Declaration on Risk Management & Internal Controls

Attractiveness of the UK for talent and investment

The UK economy continues to struggle to recover from the impact of the Covid pandemic and the uncertainty created by the impact of other factors such as Brexit has further impacted our relative position in the global capital markets. This restricts the ability of British businesses to attract global investment and to recruit talent – both of which are critical to deliver on the necessary growth ambitions for the UK.

We urge you to ensure that the steps taken to deliver on the ambitions of the corporate governance reform project focus on the fundamental ambitions and do not further differentiate the UK Market from our international peers. When we surveyed our membership earlier this year and asked them about the prospect of a dual listing or changing their primary listing to outside of the UK, only 50% of respondents said that they 'are not considering it', with 'regulatory pressure' cited as the most common influencing factor.

By way of an example, a control framework that has no equivalence with US SOx, or indeed any other international financial reporting control regimes, will only make the UK a less attractive place for investment and talent. And the impact on talent recruitment and retention is felt most keenly at the Audit committee, in particular the Chair position, where arguably talent would have greatest opportunity to deliver on the governance reform agenda.

Ensuring proper cost vs benefit analysis to keep any final changes proportionate

Finally, we would urge you to ensure that all cost vs benefit analysis are thorough, complete and suitably consulted on to ensure that all proposals are proportionate. This will be most relevant where guidance is anticipated – once the specifics of what will be required are understood more detailed cost analysis can be performed to determine the proportionality of the proposal. Our current interpretation of the proposals have associated costs which in our view are significantly beyond proportionate.

We hope that you find these comments and our responses below useful, and we thank you for the opportunity to share them with you. We would be happy to discuss them in further detail if you saw a benefit in such an opportunity.

Yours sincerely,

Main Committee of the Hundred Group

100 Group responses to individual questions raised in the consultation

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

While we support the ambition to deliver more outcomes based reporting, we believe that as drafted the requirement is neither clear nor explicit enough to deliver on this.

The current wording, including undefined terms such as 'governance activity' and 'governance practices', is unlikely to drive anything other than boilerplate disclosure in our view. We would suggest leveraging the more specific and widely understood wording from the Listing Rules: LR 9.8.6(5) already requires listed companies to report on "how the principles of the code have been applied". Leveraging this well-established wording allows for existing reporting to act as a precedent for what is expected and will ensure consistency of application across all Code companies, listed and non-listed.

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?

The proposed changes to Provision 1 are, in our view, duplicative of similar requirements already mandated by the Companies Act S172 and the listing rules.

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

Provision 3 has been amended to mandate engagement with shareholders (as opposed to seeking it) and to report on the outcomes of the engagement that has taken place. In our experience engagement with shareholders is very difficult to achieve where they have no specific or particular interest. Investment houses run increasingly streamlined processes relying more and more on proxy advisors and ratings agencies for most of their investments – agencies and advisors who in our experience are not interested in engaging prior to making their recommendation. Further, we find that Investors (shareholders) with the capacity and appetite to offer challenging engagement while few, and reducing in number, already have suitable existing channels to engage through.

As noted by the FRC yourselves in the conclusion of your recent research paper into proxy advisors "*the ability of companies to engage with their major shareholders may be related to the size of the company and the composition of its share register. Investor interviewees said that their decision on which companies to engage with were primarily driven by their own priorities rather than in response to requests from companies.*"

It is our position that mandating engagement by the businesses where the investment community is not equally compelled cannot be expected to have a significant impact on behavioural change.

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?

No. We are of the view that the Board Performance review should focus on the outcomes of the Board and whether, or not, they are achieving them. This must necessarily be considered in the context of the Board as a Group and the relative capacity of individuals based on their external appointments need not be as relevant to this assessment as their skills and the specific time that they have afforded to the role.

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 are unclear on what outcomes are being sought through increasing transparency on director's commitments to other organisations. Individuals will have many different calls on their time and capacity, and other appointments may not even be the greatest of these. To attempt to assess a director's capacity to undertake their role effectively by counting up their other positions is completely unsuitable, and to try to assess it any more deeply would need a level of detail requiring pages of explanation, as well as being wholly inappropriate in terms of the individual's right to privacy. Such an assessment would also undoubtedly have greater significance to less represented groups on Boards and may thereby slow progress in the Board diversity improvement agenda.

Further, a socially important consequence would be the almost inevitable decline in non-executives willing to sit in voluntary roles, for example as trustees of charities or other not-for-profit organisations, a move for which the most vulnerable would be paying the price.

Finally, if this provision were to go ahead as proposed then more guidance will be required on what disclosures are expected.

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

We have no comment to make on the proposed changes.

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?

We are absolutely clear on the value of a diverse board, and we agree that this goes beyond the traditional measures of gender, social and ethnic backgrounds. However, while the ambition in the proposal is clear and admirable, there is a risk that by defining diversity as 'protected characteristics and non-protected characteristics' you land so broadly as to make the requirement almost meaningless.

We appreciate the desire to define the term but perhaps restricting the phraseology to maintaining / having a 'diverse and more inclusive board' would be better.

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

It is our view, that by their very nature, succession planning and senior appointments cannot be reported on in a transparent way as they are highly sensitive and confidential activities. Further, references to pipelines do not acknowledge that, for non-executive roles in particular, any slate of candidates may only be available for a limited period and so cannot properly be considered a pipeline.

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 have no comment to make on the proposed changes.

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

We see the value of the Audit and Assurance Policy (AAP) in principle, as a tool to support great Governance across the market, and we agree that one should be prepared by all Code companies. However, we feel that there is a lot of work to be done on definitions before the AAP can fulfil its intended role.

Scope, expectation and alignment

Clarity is required over the intended scope of the AAP and its interaction with the Audit Committee's responsibility to review the company's risk management and internal control systems. As drafted, the statutory instrument specifically calls out the need for the Audit Committee to take responsibility for financial and related narrative reporting – which would indicate that the scope is intentionally narrower than their existing responsibility to review risk management and internal control systems.

And linked to the above, clarity is required around how the AAP aligns to, or interacts with, the Directors declaration on risk management and internal control systems effectiveness. Do they both cover the same breadth and depth of controls for example? Or would you expect one to be a subset of the other? Or do they have overlapping components? In particular, is it anticipated that the AAP capture controls over operational and compliance risks such as those disclosed in the Principal Risks and Uncertainties statement? Clarity over this interaction will be key to ensuring consistent treatment.

The answers to questions such as those raised in this section of our response need to be made explicit, if not within the Code itself then at a minimum within the guidance which must be available at the point of release of the Code.

Assurance

Where the Code references the types of assurance to be obtained, this invariably refers to external assurance. While we appreciate that this does not in itself create an explicit requirement to obtain external assurance, it being raised in this way will undoubtedly influence the decisions of risk averse directors, as well as the positioning from assurance providers.

Most large PIEs have experienced internal assurance, and well established three lines of defence models, on which boards and senior management, regulators and other stakeholders, regularly place reliance. It is important that the code does not create the perception that high quality assurance is only provided by external parties.

We believe that the intended outcome would be better achieved by referencing assurance in the context of 'level of assurance' as opposed to using language such as internal or external.

In addition, linked to the above, clarity would be welcomed on expectations of assurance over reporting, operational and compliance controls for the purposes of the Directors declaration on effectiveness. In particular, the use of the words 'reasonably conclude' may not be helpful as they may indicate that 'reasonable assurance' opinions should be sought which is a very high standard of assurance under ISAE3000 Revised and rarely provided by external accounting firms.

Engagement

Without wishing to repeat all the points in our response submission to the 'Draft Minimum Standards for Audit Committees Consultation' from earlier this year, a critical one is amplified within the Code itself and so in our view warrants comment. As we said in February, we do not support the need for additional shareholder engagement on the subject of the audit.

It is our view that shareholders already have ample opportunity to engage through existing mechanisms and in practice our members have experienced limited engagement from investors specifically on audit and assurance related matters. We are of the view that the AGM remains the appropriate place for interventions of this sort and that mandating (albeit under comply or explain) engagement on specific topics via the Minimum Standards is not appropriate.

The code introduces the requirement for the Audit Committee to engage with shareholders and other stakeholders. As drafted this requirement is, in our view, completely unachievable. There are two reasons for this.

- Firstly, there is the issue of scope – there is a lack of definition around who are the stakeholders within whom the Committee need to engage once defined this poses a practical point around the sheer impossibility of 'engaging' to any level of value with such a vast group.
- And secondly there is the question of purpose – to what end is this engagement being sought? The Committee could reasonably be expected to communicate their position on certain matters, but to be led in any way by a Group of stakeholders, quite likely without any particular knowledge of the business structure or the technical topic in question, would be, in our view, totally inappropriate.

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, referring to the minimum standards avoids duplication within the Code, however the minimum standards themselves pose some additional questions which need to be resolved and are made more pertinent by them now being reference from within the Code, including some duplication between the two.

While we are supportive of referencing the Audit Committee minimum standards in principle, both these, and this section of the Code require further work to ensure that requirements are clear and are targeted where they will have the most appropriate impact on the quality of reporting.

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

No. PIE Boards will each have their own unique structures and ways of working which have been developed over time based on the structure of their business. To challenge such structures is absolutely right and happens through internal self-assessments as well as from external assurance providers, advisors and regulators. However, to mandate allocation of specific activities to the Audit Committee when they already form part of the remit of another Committee will not improve governance – indeed in many cases it may impede it through overburdening. Many Audit Committees already meet for half a day six times a year and have additional time commitments between meetings. To increase the workload would both impact on their ability to deliver on the responsibilities of the role and would inevitably narrow the field of candidates willing to take on these critical positions on PIE Boards.

This is also a clear articulation of the risks associated with assuming that the comply or explain model offers businesses the flexibility to do what they feel best if it differs from the comply. Such easily identified deviations from the 'best practice' laid out by the Code are ideal opportunities for proxy and activist voters to create impact. Many companies have established Sustainability or ESG sub-committees of the Board which currently assume responsibility for oversight of ESG programmes and related narrative reporting. The code and associated guidance must recognise this and articulate clear confirmation that this continues to be appropriate given the changes proposed to the Code.

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?

No, the proposal is not proportionate.

We maintain the position that we articulated in our response to the Government's 2021 consultation on "restoring trust in audit and corporate governance", the relevant extract of which is included as Appendix 1 to this response. Without wishing to revisit in detail what we have previously written, our view of proportionate implementation relied on six factors – five of which have explicitly not been met, and the final one of which remains open to interpretation:

- The scope must be restricted to controls over financial reporting;
- There must be international equivalence with overseas frameworks (e.g. US SOx which apples to 22% of the FTSE100);

- Principles and guidance must carefully balance prescriptive requirements and unambiguous definitions with flexibility – albeit the guidance is not yet available the market response to the principles as drafted show them to be absolutely ambiguous;
- Decisions regarding the level of assurance over internal control disclosures must remain with audit committees;
- Director sign off must be limited to the executive given the necessary knowledge gap between the operational role of the executive and the supervisory role of the non-executives

The proposal for continuous monitoring, a principle which was not even aired as part of the consultation process, compounds the disproportionality of the proposals still further.

Beyond the question of proportionality, we see the code as drafted as insufficiently detailed.

Finally, we note that the impact assessment as released 10/07/2023, considers only the additional cost associated with meeting the reporting requirements – not with any additional effort required to ensure (Non-Executive) Directors are comfortable to sign off on such an external disclosure. Our membership experience shows that the latter requires more extensive evidence, validation and assurance than Management would require to arrive at a similar conclusion as part of their normal course of business.

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?

The Board's declaration must be based on the date of the balance sheet (which would also align with SOx reporting requirements, for example). Continuous monitoring is, in our view, totally unachievable and affords no additional benefit to the user.

Additionally, while there is no guidance, and without any generally accepted principles from within other frameworks to look to, it is not even possible to imagine what would be required in order to support a sign off of continuous monitoring. The sorts of questions that we ask ourselves include: How often should I be testing? How quickly do I need to remediate a weakness or a failure before being obliged to report it? Or do I always need to report a weakness or failure of a material control? In which case where is the incentive to resolve them quickly? When considering the period between the balance sheet date and the reporting date, how does this sign off interact with the post balance sheet events obligations? And does the same measure of materiality apply here to these weaknesses as to the rest of the audit (see our response to Q17). And logistically, how is comfort over controls to be obtained throughout this period right up to the moment of issuing the financial statements?

Beyond the time coverage aspect of the declaration, greater clarity is also needed around what the statement should cover. What level of detail is required around the controls identified; the process to test them; and what and how much to say about any findings?

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?

No, the reference should remain as 'financial' controls and the scope should be limited to controls over financial reporting.

While we understand the FRCs ambition to future proof the code, at a time when the financial and non-financial reporting sector is evolving at exponential levels, attempting to develop a principles-based code that will grow with whatever comes is, in our view, an unachievable ambition that will leave UK governance the worse for having tried.

While increased ESG reporting is no doubt the direction of travel, the difference in maturity of controls around these processes, when compared to financial reporting ones, must be appreciated. To attempt to report on them through one lens, with the same level of expectations, will only succeed in undermining all reported ESG data. This in turn will create increased scepticism in the market around ESG reporting and thereby negatively impact on the overall ambition to drive change towards responsible investment.

A more fundamental question that remains to be answered is whether, under these proposals as drafted, a business can bring a metric to the Annual Report that does not have a solid control framework behind it. If for example a business identifies a new risk, are they able to include commentary around it within the annual report if they have not yet developed a robust framework of controls to measure and control it? Our membership are absolutely committed to the ambition for well controlled ESG reporting, but they are all clear that this will take some time and rushing to treat narrative ESG reporting with the same scrutiny as financial reporting controls will not work in favour of anyone and will only place undue stress on businesses and on the market.

And finally, at a principle level, restricting reporting to 'controls over financial reporting' would allow for some level of equivalence with already existing frameworks, e.g. US SOx which is an absolute priority for our membership – our Group is formed of FTSE100 companies, of which 22% are US overseas registrants and therefore subject to SOx 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?

Guidance should absolutely set out examples of methodologies or frameworks that can be used to support management's review of risk and controls.

Frameworks currently in operation include the Committee of Sponsoring Organisations of the Treadway Commission (COSO) framework and the Financial Position and Prospects Procedures (FPPP), in addition to which the Audit Committee Chairs' Independent Forum (ACCIF) have developed draft principles to support a CEO/CFO attestation to the board about internal controls over financial reporting. In our view using the FPPP framework would be too detailed for an annual review while the ACCIF draft principles would require further development to provide a practical framework.

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?

Each business will have their own definition of a material weakness and it will often include a reference to the item being escalated to the Board. The important factor to consider when drafting any such definition is that businesses necessarily operate on the basis of seeking reasonable assurance that the overall control framework is effective within the parameters of their own risk appetite. An ambition to be perfect and error free is not suitable for any process operating at scale – and in our view, targeted and speedy intervention and correction of errors is a far more worthy ambition. Any definition of materiality must reflect this and also be consistent with those in other regulations.

The definition as currently drafted and presented in paragraph 70 of the consultation document sets far too low a bar to be workable in the context of the proposed requirements set out in the code.

Further, we would recommend that guidance for assurance providers also be released alongside the guidance for preparers. Unless definitions are absolutely specific, then there is always the tendency to push for the inclusion of more. In our view this miss-match devalues the reporting, as well as applying undue pressure on the relationship between companies and their auditor.

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

The guidance should cover all aspects of the code. Guidance on areas not explicitly required by the code should be avoided, in particular if it is to be prepared at the cost of more detail on areas from within the Code.

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)?

The location of such disclosures is not of significant concern to our membership – our only concern is that nothing becomes duplicative. We do not have a position on the preparedness of non-PIE companies.

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

We have no comment to make on this matter.

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?

We do not have a position on the preparedness of non-PIE companies.

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

We have no comment to make on this matter.

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

We support the approach taken to malus and clawback which allows companies to tailor their malus and clawback policies to their particular needs and we agree that the proposed reporting changes will improve transparency.

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

We welcome the deletion of the existing Provision 40 and the removal of the consequential reporting requirement in Provision 41, which in our view will reduce unnecessary boilerplate reporting.

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

We have no comment to make on this matter.

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?

In our view, such detailed amendments are not appropriate for the Code and associated guidance, which is necessarily and deliberately high level and broad. While artificial intelligence is very topical, it is just one in a series of technology advancements which may bring new risks to businesses. It will therefore already be covered by the Code requirements on principal risks and emerging risks and does not warrant explicit mention.

Further, the legislative position on artificial intelligence in the UK, and internationally, is still evolving, and so any such amendment or guidance would most likely become outdated in the near-term. We do not consider that any amendment or guidance around artificial intelligence is either desirable or warranted.

2.1	**Stronger internal company controls**
12	*Is there a case for strengthening the internal control framework for UK companies? What would you see as the principal benefits and disbenefits of stronger regulation of internal controls? (49)*
100G response	Strengthening the internal controls framework for UK companies should improve standards and consistency both between companies and with other jurisdictions, driving increased investor confidence. Whilst maintaining appropriate accounting records and controls are already requirements derived from the Companies Act 2006, the Listing Rules and the UK Corporate Governance Code, this objective can be achieved in a variety of ways. The principal disbenefit will be an increase in cost for preparers, the quantum of which will be dependent on the scope of controls considered, assurance requirements and equivalence with other internal control regimes. In our view, a disproportionate increase in requirements would have an impact on the attractiveness of the UK as a prime location for businesses. For example, we would have significant concerns if any new control environment was similar to or more burdensome than US SOX or reached wider than financial reporting controls. Our members that apply US SOX note that the additional time and cost it places on a business is significant and should not be underestimated, especially in the first few years of implementation. We also expect that there will be significant resource constraint amongst issuers, auditors and the regulator during implementation to ensure existing reporting timeframes and the issuance of annual reports are not jeopardised.
13	*If the control framework were to be strengthened, would you support the Government's initial preferred option (Table 2)? Are there other options that you think Government should consider? Should external audit and assurance of the internal controls be mandatory? (49)*
100G response	In our view for the proposals to be successful the scope of the regime will need to be limited to the controls over financial reporting, there will need to be suitable international alignment, stakeholder engagement will be needed to develop suitable principles and guidance and assurance should not be mandatory. Further details on each of these points are included below. <u>Scope of controls under review</u> The scope of controls under review should be limited to financial reporting controls only as these can be firmly anchored to the financial statements. This would align with the scope of control frameworks that exist in other jurisdictions and address what we understand to be the intent of the consultation. Expanding the scope to include all financial controls or even all internal controls would significantly increase both the implementation costs and ongoing financial and compliance burdens on companies and would result in overlaps with other regulators. For example, there are already suitable regulations around how medical devices are manufactured or how the health and safety of employees is maintained. Furthermore, if non-financial reporting controls were included the definition of materiality for a disclosable deficiency would be very subjective leading to inconsistent and confusing interpretations. Disclosure of deficiencies in areas such as cyber, data and legal compliance could also limit internal transparency through a disincentive to report internally. <u>International alignment</u> Implementation of a regime equivalent to or more burdensome than full US SOX would be disproportionate for many of the companies within the proposed scope of the requirements. Further, any requirements and guidance on the application of the new control framework should be based on the application by companies, not, like it is in the US, through a series of auditing standards that companies then have to interpret. However, any UK internal control regime will need to be compatible with controls frameworks in other jurisdictions in order to avoid unnecessary duplication of costs, effort and reporting for dual listed companies. For example, compliance with US SOX (at a more detailed level) should achieve compliance with any new UK control framework. <u>Principles and guidance</u> Principles and guidance will need to carefully balance prescriptive requirements and unambiguous definitions with flexibility. Flexibility will be needed to allow management to implement requirements appropriately for their business and industry and to avoid assessments of internal controls becoming a tick box exercise rather than a proactive risk management procedure.

However, a framework that is not sufficiently prescriptive will not generate the desired market consistency, would result in increased complexities thus increased costs and would create challenges in reaching conclusions between companies and auditors. If the UK regime is not sufficiently well defined it is likely that management and auditors will revert to using existing frameworks such as US SOX as a basis for their own framework design and implementation.

Particular consideration will need to be given to guidance around the disclosure of deficiencies. Any requirements will need to reflect a form of materiality while remaining specific enough to ensure that significant deficiencies are disclosed despite the disincentive to report. In our view the disclosure of non material deficiencies could result in the reporting of a high number of deficiencies. While individually and in aggregate these may not give rise to a material risk of misstatement, such disclosure would be disproportionately interpreted by investors.

Frameworks currently in operation include the Committee of Sponsoring Organisations of the Treadway Commission (COSO) framework and the Financial Position and Prospects Procedures (FPPP), in addition to which the Audit Committee Chairs' Independent Forum (ACCIF) have developed draft principles to support a CEO/CFO attestation to the board about internal controls over financial reporting. In our view using the FPPP framework would be too detailed for an annual review while the ACCIF draft principles would require further development to provide a practical framework.

We encourage the regulator to actively engage with stakeholders as detailed principles and guidance are developed to ensure that they are fit for purpose, including through a consultation process.

<u>Audit and assurance</u>

We agree that decisions regarding the level and extent of external audit and assurance over internal control disclosures should remain with audit committees and stakeholders as part of the proposed Audit and Assurance Policy (AAP), unless there have been persistent material control weaknesses. This will allow organisations to tailor the type and extent of assurance to their investors, risk appetite, and budget while reflecting the work already performed by their internal audit teams.

Clear guidance as to what constitutes persistent 'material control weakness' or a "serious and demonstrable failure of internal controls" will be needed for businesses to identify when external assurance over internal controls is required.

When auditors are required to express an opinion on the assessment of internal controls, it will need to be clear as to whether that opinion is based on a framework and compliance approach as per a company's approved audit and assurance policy or the standards required for a controls based audit opinion (which are largely based on US SOX requirements). It will also be important for users to understand the difference between these two approaches.

Where assurance is obtained over internal controls, we recommend that audit fee caps are adjusted to include this work. Given the level of overlap with the work that auditors already perform over financial reporting internal controls it would be inefficient to use a different provider.

The majority of our members do not support *requiring* auditors to express a formal opinion on the directors' assessment of the effectiveness of internal controls. This could disproportionally increase the cost burden for preparers making the UK a less attractive market and further increase the barriers to using smaller audit firms. Companies would also need additional time both to implement any proposals that incorporate this requirement and to perform their annual audits which may be incompatible with the reporting deadlines imposed on entities reporting in other jurisdictions.

Auditors are already required to state whether the strategic report and corporate governance disclosures are consistent with the financial statements and their knowledge obtained during the audit and they regularly undertake work to understand a company's internal control systems when determining their audit approach.

Therefore, should investors require more assurance than the proposed approach presented in Table 2, we favour increasing audit report disclosures to include details of the work performed and the extent to which auditors have placed reliance on controls.

<u>Director attestation</u>

There is necessarily a significant knowledge gap between executives and non-executives as a result of their roles and responsibilities. Non-executive directors, have a supervisory role, holding management to account through constructive challenge, strategic guidance and specialist advice, while executives are involved in the day to day running of the business. It will be important to avoid creating unnecessary burdens to get non-executives comfortable with attestations outside the scope of their role, which would be exacerbated in an environment of increased enforcement, while maintaining the integrity of the unitary board.