20 July 2012

Our ref: ICAEW Rep 93/12

Chris Hodge
Financial Reporting Council
Fifth Floor
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By email: codereview@frc.org.uk

Dear Chris

Revisions to the UK Corporate Governance Code and Guidance on Audit Committees, and the UK Stewardship Code

ICAEW is pleased to respond to your request for comments on the above consultation drafts.

Please contact me should you wish to discuss any of the points we have raised.

Yours sincerely

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ICAEW REP 93/12

ICAEW REPRESENTATION

REVISIONS TO THE UK CORPORATE GOVERNANCE CODE AND GUIDANCE ON AUDIT COMMITTEES, AND THE UK STEWARDSHIP CODE

Memorandum of comment submitted in July 2012 by ICAEW in response to the Financial Reporting Council Revisions to the UK Corporate Governance Code and Guidance on Audit Committees, and the UK Stewardship Code published in April 2012

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INTRODUCTION

1. ICAEW welcomes the opportunity to comment on the consultation papers *Revisions to the UK Corporate Governance Code and Guidance on Audit Committees* and *Revisions to the UK Stewardship Code* published by the Financial Reporting Council in April 2012. This response should be read in conjunction with ICAEW's responses to the FRC's other consultation paper *Proposed revisions to international standards on auditing (UK and Ireland) to give effect to the FRC effective company stewardship proposals* (ICAEW Rep 92/12) published by the Financial Reporting Council also in April 2012.

WHO WE ARE

2. ICAEW is a world-leading professional accountancy body. We operate under a Royal Charter, working in the public interest. ICAEW's regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the UK Financial Reporting Council. We provide leadership and practical support to over 138,000 member chartered accountants in more than 160 countries, working with governments, regulators and industry in order to ensure that the highest standards are maintained.

3. ICAEW members operate across a wide range of areas in business, practice and the public sector. They provide financial expertise and guidance based on the highest professional, technical and ethical standards. They are trained to provide clarity and apply rigour, and so help create long-term sustainable economic value.

4. This response reflects consultation with the ICAEW Corporate Governance Committee which includes representatives from the business and investment communities. The Committee is responsible for ICAEW policy on corporate governance issues and related submissions to regulators and other external bodies. The response also reflects input from the ICAEW Financial Reporting and Audit and Assurance Faculties.

MAJOR POINTS

5. ICAEW supports the overarching objectives of the FRC's consultations to revise the UK Corporate Governance Code and Guidance on Audit Committees, and the UK Stewardship Code. We have previously welcomed the overarching objectives of *Effective company stewardship: Enhancing corporate reporting and audit* (January 2011) in our response (ICAEW Rep 34/11) to that consultation.

6. We stated in the previous response that we support the FRC's work to develop effective, workable proposals that facilitate greater transparency. We have contributed to a number of subsequent consultations, including our responses to *Going concern and liquidity risks: Lessons for companies and auditors* (ICAEW Rep 3/12) and *The future of narrative reporting* (ICAEW Rep 117/11). We have also issued a Stewardship Supplement to AAF 01/06 *Assurance reports on internal controls of service organisations made available to third parties* intended to enable independent assurance reporting on the UK Stewardship Code.

7. Our support for a number of proposed and existing requirements in the Codes is in the context of a 'comply or explain' basis. We would be concerned if the inclusion of these requirements in the UK Codes was used as a basis for introducing mandatory requirements in Europe.

8. We have reservations regarding a number of the current proposals. Some would benefit from further clarification. Others should be reconsidered to ensure their contribution to transparency is not outweighed by the risk of additional clutter or disproportionate burdens on companies.

COMMENTS ON PROPOSED CHANGES

Revisions to the UK Corporate Governance Code and Guidance on Audit Committees

Effective Company Stewardship

Striking the right balance between changes to the UK Corporate Governance Code and Guidance on Audit Committees

9. The balance between changes to the Code and *Guidance on Audit Committees* is broadly appropriate. We support the Code setting out requirements on a 'comply or explain' basis and *Guidance on Audit Committee* being introduced as best practice guidance. This should enable companies to apply the proposals in a workable and proportionate way.

Applicability of the new requirements of the Code

10. We do not believe that changes should be applied initially to all listed companies. Admittedly the option is there for smaller companies to explain rather than to comply with the requirements. However, drafting clear explanations that meet the needs of shareholders can be a significant requirement.

11. In order to enable further impact assessments to be undertaken based on practical experience and to make necessary adjustments, we believe that other new requirements could in the first instance be made applicable to larger listed companies as with the regular tendering requirement. The initial consultation suggested this was a possibility and we support the idea.

Extended remit of audit committees

12. Under the proposed revised UK Corporate Governance Code, the audit committee is now provided with the remit to consider the whole annual report with a view to advising the board whether it is 'fair, balanced and understandable and provides the information necessary for users to assess the company's performance, business model and strategy.'

13. While we are generally supportive of the audit committee, a committee accountable to the board, being given an enhanced remit, we question what improvement in reporting quality this specific proposal would achieve in practice. The board already has full oversight responsibility for the accounts to give a true and fair view with or without the challenge from the audit committee. We wonder if this new requirement will be seen as placing an additional burden on audit committees and confuse the concept of the unitary board.

14. We appreciate that the FRC wishes to take a leadership position in the European corporate governance debate. However, we have two concerns. Firstly, because audit committees are relatively recently introduced in many European jurisdictions, the FRC's proposal to extend the remit of audit committees may appear too demanding and may reduce the FRC's influence. Secondly, there is a danger that UK companies may be disadvantaged unless any additional requirement placed on them results in a demonstrably lower cost of capital.

Proposed Provision C.1.3 on the board requirement to explain why they believe that the annual report is fair, balanced and understandable and that the disclosures give users information necessary to understand the business model and strategy

15. The proposed revised UK Corporate Governance Code requires boards to assert in the annual report the basis on which they consider the report to be fair, balanced and understandable. This is intended to ensure that companies provide key information and sensitivities in their annual reports.

16. We are sceptical as to what the proposal would achieve in practice. Boards may assert that they used their best endeavours to ensure that the annual report is fair, balanced and understandable, but such assertions may mean little if subsequently this turns out not to be the case. On that basis, we suggest that the existing main and supporting principles under C.1 should suffice: the board is responsible for presenting a fair, balanced and understandable assessment of the company's position and prospects in relevant reports. This is furthermore supported by the disclosure requirement under International Accounting Standard 1 and other relevant standards relating to key judgements and estimates made in preparing the accounts.

17. Disclosures regarding the basis of the board consideration may become boiler plate and add clutter to the annual report if companies provide a generic description of processes, without necessarily enhancing transparency. In theory, this could be useful as a subject for board-investor dialogue: however, once it has passed the internal approval process for publication in the annual report, its value may become much reduced. We propose that this new provision should be removed. Instead we recommend that the existing requirement is reinforced. To this end, it may be useful for the Financial Reporting Review Panel to focus on the required disclosures in its future work plan.

18. On a similar basis, we consider that there is limited value in the requirement to explain why the directors consider that the annual report gives users the information necessary to assess the company's performance, business model and strategy. There is a risk of misleading investors by holding out the annual report as the perfect investment assessment tool rather than part of the information required to assess a company's performance, business model and strategy. We suggest that this requirement should be removed.

Conceptual underpinning of the contents of annual reports

19. We support the requirement that the annual report needs to be fair, balanced and understandable under Principle C.1, even though we question the value of boards explaining **why** they believe this to be so.

20. This requirement for the annual report to satisfy qualitative characteristics has largely existed within the Code, and we consider that these concepts are generally well understood in the context of annual reports. For example, accounting standards provide that the purpose of financial information is to be useful for current and future investors in making economic decisions and these users are expected to have the requisite financial knowledge. The IASB also explains qualitative characteristics of useful financial information in its *Conceptual framework for financial reporting*.

21. It might be helpful if the Code refers to relevant authoritative documents in footnotes so as to enhance the clarity of application. Alternatively, the Code may expressly state that the primary users of the annual report in this context are investors with the requisite financial knowledge.

Transitional arrangements for the introduction of audit tendering

22. As a general aim, we support more frequent tendering which may help alleviate the perception that long tenure reduces audit quality and auditor independence. While unconditional mandatory tendering would add significant costs for both companies and auditors, the negative impact can be limited if this requirement is introduced on a 'comply or explain' basis. We therefore support the proposal introducing a minimum tendering requirement of every ten years on a 'comply or explain' basis.

23. Furthermore, we support enhanced communication over audit tenure, the period since the last tender, and tender and selection processes. The nature of this information is straightforward and should help meet the information needs of investors to assess the effectiveness of the external auditor.

24. In introducing this proposal, we believe that it is essential that a 'comply or explain' basis is fully integrated into the process of making a tendering decision. The proposal could be supportable as an alternative to mandatory rotation, provided 'explain' is a genuine alternative to 'comply.' We consider that this may assist competition without imposing cost for the sake of it. Clearly there are relevant international developments in this area, and we assume that the FRC will take these developments into consideration.

The quality of explanations

Background and guidance on meaningful explanation

25. We support the addition of background and guidance on meaningful explanations in the 'comply or explain' approach. Meaningful explanations are essential in implementing the UK corporate governance framework rigorously. Setting out the key features of meaningful explanations in the introduction to the Code would be a useful reference point for both boards and shareholders.

Other proposed changes

26. We support other changes intended to enhance transparency over the way boards discharge governance responsibilities to advance company stewardship. These include the new reference to the interest of debt holders and other providers of non-equity capital to address the needs of non-equity capital providers and additional disclosure requirements in B.2.4, B.6.2 and D.2.1.

Revisions to the UK Stewardship Code

Rationale and summary of the proposed changes

27. It is important that the Stewardship Code is drafted and read so that its overall objective is understood within a broader context of the UK corporate governance framework. Investor stewardship is an integral part of a market economy which benefits companies and investors by holding publicly listed companies to account for the fulfilment of their responsibilities. The Stewardship Code as a whole helps to achieve this objective and we believe that it is by and large well-structured, balanced and clear in the light of this objective.

28. Two tests that the FRC applies when proposing changes are useful. We support proposals to facilitate better understanding and, consequently, better application of the Code that can bring about real behavioural changes without undue prescription. It may be also beneficial to consider the expected costs and benefits of the proposed changes as the changes are unlikely to win support of the signatories unless they are proportionate. This is not to say that we would discourage the introduction of proposals that are unpopular primarily due to the cost: certain proposals may incur costs upfront which might appear disproportionate initially, but they may deliver significant value over time.

Matters raised in 'Developments in Corporate Governance 2011'

The definition of stewardship

29. Together with revamped introduction sections, revised Principle 1 better sets out the description of stewardship and its purpose. We are particularly supportive of the related restructured guidance which sets out an overview of stewardship responsibilities.

30. We agree that there needs to be clear understanding as to what stewardship means in the context of the Stewardship Code, notwithstanding that there are other definitions of stewardship that may be equally important in different contexts. The objective of the Stewardship Code is to further strengthen the UK corporate governance framework, of which investor stewardship is an integral part. If this understanding is not shared among investors and users, there is a risk of the Stewardship Code being criticised for not addressing objectives that it does not set out to address.

The role of asset owners and asset managers

31. Revisions to differentiate asset owners and asset managers in the introductory sections are useful. A lack of clear understanding of their respective nature and responsibilities can potentially cause confusion as to how the Stewardship Code is applied. Considering the importance of this point, it may be useful to bring the relevant explanations under a separate heading as they are currently embedded in several places within the introductory sections.

32. We agree that the division of duties within and between institutions may span a spectrum and support the suggestion for institutions to consider where on the spectrum they sit. This however would be of limited usefulness unless they link that consideration to the application of the Stewardship Code and communicate the point to the users of their stewardship statements. We therefore propose that institutions expressly state how they define their role in the context of applying the Stewardship Code.

Other proposed changes

Assurance reporting

33. ICAEW issued the Stewardship Supplement to practice guidance Technical Release 01/06, *Assurance reports on internal controls of service organisations made available to third parties*. The Supplement is intended to support the application of Principle 7 of the Stewardship Code and provides reporting accountants with guidance to give an assurance conclusion on the fairness of description of how Principles 1, 2, 6 and 7 have been applied and the disclosure of specific information listed under these Principles.

34. To develop a robust framework of assurance reporting with regard to the Stewardship Code, the publication of the Supplement was delayed until March 2011. Due to the timing, the adoption of assurance reports has been limited to date, although we note that there is increasing support for assurance reporting from clients and beneficiaries of institutional investors.

35. The FRC has proposed strengthening the requirement for independent assurance in Principle 7. We agree with this requirement on a ‘comply or explain’ basis. The value of independent assurance needs to be proportionate to the needs of users. While the starting point may be for institutional investors to obtain an independent assurance opinion, there should be an option for institutional investors to explain that they are not obtaining one if their clients and beneficiaries do not see proportionate long term value in having such an opinion.

36. The replacement of the word ‘robust’ with ‘effective’ in Principle 2 will present difficulties for assurance reporting based on AAF 01/06. The word ‘effective’ seems to imply that asset managers’ relevant policies and procedures are effective, assessed in terms of design or operation. This would consequently create an expectation that assurance reporting extends to cover design or operating effectiveness, which is currently outside the scope. We therefore support reinstating ‘robust’ in Principle 2 or instead using ‘rigorous’ which may be easier to demonstrate than ‘robust.’

37. Principle 7 refers to client access to assurance reports on institutional investors’ stewardship statements. We are aware of similar difficulties encountered by users of other internal controls assurance reports, and have developed relevant explanatory material. This will be made publicly available on our website and we will advise you when this goes live.

38. We intend to introduce conforming changes to the Supplement so as to support the application of the revised Stewardship Code in time for its scheduled effective date. In doing so, we will also consider whether Principles that are currently outside the scope may be covered within the scope of assurance reporting. We will consult stakeholders including asset owners, asset managers and assurance practitioners among other interested parties represented in the AAF 01/06 working party and the stakeholder panel of the Audit and Assurance Faculty. We will, of course, liaise with the FRC during this process and discuss detailed drafting.

39. We have drafting suggestions related to references to the ICAEW Stewardship Supplement to AAF 01/06 and the ICAEW Audit and Assurance Faculty will write to you separately on these points.

Other changes

40. Other proposed changes are useful, in particular the disclosure requirement on the policy of stock lending and the use of proxy voting services by institutional investors. Regarding proxy voting services, this growing practice presents a major challenge to constructive engagement between companies and institutional investors. We therefore welcome enhanced transparency in these areas.

41. We support the FRC's position that the Stewardship Code should be applied more widely. It would be beneficial, by way of enhanced transparency, for the clients and beneficiaries of institutional investors to understand the extent to which the Stewardship Code has been applied to the funds under their management, including overseas equities. Equally, we would welcome overseas investors demonstrating their commitment to stewardship responsibilities, either by following the Stewardship Code or an equivalent.

42. Finally, we observe that there is an emerging trend whereby voting decisions and governance matters are separately carried out within investor organisations: fund managers discussing performance and strategy issues with management while an in-house, or sometimes external, governance team engages with non-executive directors on governance matters. We believe that these functions should not be separate. The emerging disconnect means that communication between shareholders, non-executive directors and boards may become disjointed and ineffective, ultimately reducing the value of investor stewardship.

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