UK Corporate Governance Consultation Response

BDO welcomes the opportunity to input into the FRC's consultation on the Corporate Governance Code and supports efforts to enhance the Code's effectiveness in promoting good corporate governance.

As we all know, the UK economy is under a lot of pressure. The post-COVID recalibration of business, high inflation and global geopolitical tensions, coupled with ongoing labour shortages and supply chain issues, have created volatile markets that we have all had to navigate.

Any changes made to the Corporate Governance code, or to the way in which businesses operate in the UK, must provide stability and the conditions needed for growth. It must also help companies to refocus and align corporate governance to their strategy, values and purpose. If we get this right, businesses will welcome clearer rules and a stronger foundation from which to work from, in turn bolstering confidence in British business, attracting global capital and growing our economy. If we get this wrong however, we risk overburdening already struggling businesses, deterring foreign investment and slowing down this country's growth.

While a well performing FTSE 350 market is critical to both BDO and the rest of the economy, we will focus our response on the likely impact of these changes on the UK's 'economic engine', our mid-sized businesses. Despite making up less than 1% of total businesses in the UK, they are responsible for one in four jobs and a third of revenue and yet are often overlooked by policy makers; too big to benefit from the raft of legislation aimed at start-ups and too small to have the ear of Government.

As we will discuss in the remainder of this response, we must ensure that any changes to the code provide clarity for these businesses and avoid a catch-all approach that may disproportionately burden them. There is no doubt that mid-sized businesses must play a part in promoting good corporate governance but it is critical that this role is proportionate and time frames are realistic and gradual.

As the largest accountancy firm dedicated to this section of the economy and auditor to the largest number of AIM listed companies, we feel we are well placed to comment on behalf of them.

While Appendix A provides detailed responses to the consultation questions, we highlight below some of our key concerns.

Uncertainties relating to reporting on risk management and internal control systems

We strongly support the FRC's intention *"to provide a stronger basis for reporting on, and evidencing of, the effectiveness of internal controls (including those operating over financial reporting), but also wider operational and compliance risks"*.

However, we believe the complexity of achieving this has not been fully examined or addressed in the consultation.

There are existing approaches to identifying material weaknesses in financial reporting controls which are well understood by auditors and the Boards to which they report. What is not clear is whether the FRC envisage this same population of material weaknesses being the one to include in the Annual Report. We are not convinced that all weaknesses reported to management would be of interest to users and urge the FRC to review what is currently being reported internally as material weaknesses. Any inconsistency between internal and external reporting despite the use of the same defining terms may be confusing to users and undermine the credibility of the reporting.

Furthermore, it is less well understood how materiality applies to narrative reporting. This is a developing area and the FRC should consider further the relative merits of competing notions of materiality in sustainability reporting. In our view, the International Sustainability Standards Board's ("ISSB's") model of aligning materiality with financial reporting materiality should be followed.

It is even less clear how the notions of materiality and material weakness should be extended further to reporting on systems in place to respond to operational and compliance risks. Operational risks are an inherent part of value creation in a competitive world, and it is inevitable that some operational decisions will succeed, and some will fail. The potential for failure does not necessarily indicate a material control weakness while the potential for misstating financial information usually does.

We urge the FRC to develop and share its thinking in this area as soon as possible ahead of its proposals for revised guidance. We look forward to providing whatever assistance we can in finding resolutions to these difficult issues.

Proportionality and reliance on "comply or explain"

While changes to the definition of PIEs are yet to be legally confirmed, we do have concerns about the effective expansion of the scope to all Code companies of new legal requirements that would otherwise apply to PIEs only. We do not agree that these concerns can be mitigated, and proportionality retained, by relying on the "comply or explain" principle in the Code. In our view, this is a distortion of the purpose of the principle.

Allowing Boards to comply or explain with specific provisions of good corporate governance is intended to reflect the fact that there may be temporary reasons for non-compliance or because the specific provision is not consistent with the specific facts and circumstances a company faces – ie an alternative governance practice is considered to be more appropriate than that specified in the Code.

The expected scope of new audit and reporting requirements (such as the Audit and Assurance Policy ("AAP") and Resilience Statement) will be set by the government to achieve proportionality. While it may be simpler to create a single Code for all PIEs and non-PIEs, it is clear that this overrules, to some extent, the proportionality assessments that have been made by the government following consultation. That proportionality is only fully retained by the comply or explain principle if, as a general rule, being below a given size threshold is in itself a justification for non-compliance with the Code. Such a general rule would be a distortion of the principle as applied to date. Furthermore, it is difficult to envisage any other specific characteristic of a non-PIE code company that would provide an explanation for not making a particular disclosure statement.

Furthermore, and despite the FRC's efforts to educate stakeholders, many continue to disregard explanations as justifications for non-compliance or consider any failure to fully comply as sub-optimal. We believe that all Code companies will be under intense pressure to comply with all of the new audit related and reporting requirements, irrespective of the legal scope.

Therefore, we disagree that the Code requirements should be the same for PIEs and non-PIEs with respect to the AAP or Resilience Statement. The scope for these will be set in legislation and should not be effectively expanded by the Code. Although we recognise that having different requirements for PIEs and non-PIEs would create additional complexity in the Code, we note there is precedence for this. For example, former Provision 24 (new Provision 25) sets different requirements for smaller (ie non-FTSE 350) companies.

In our view, there are other instances where the realities faced by smaller listed companies have not been considered, so we encourage the FRC to consider proportionality again when finalising any changes. For example, it would be unreasonable to expect committee chairs to have actual engagement with, say, investors who may not have the time or inclination to engage as opposed to the current requirement for chairs to seek engagement. Smaller listed companies find it particularly difficult to achieve investor engagement despite their best efforts.

Timing of the consultation

As noted above, it is difficult to fully assess the proposals relating to risk management and internal control systems ahead of the proposed revisions to the guidance which could provide context and clarification.

In addition, there are many legislative and regulatory developments underway at the same time as this consultation. Many of the legislative changes anticipated in the government's "Restoring trust in audit and corporate governance" remain incomplete, including the enactment of changes to the definition of a "Public Interest Entity". Anticipated changes in sustainability reporting, following the publications of the first two standards of the ISSB can be foreseen.

We are concerned that by consulting now, in advance of completion of these other developments, the FRC is at risk of creating duplicative and potentially confusing reporting requirements (eg in sustainability reporting), overriding assessments made elsewhere on the scope of requirements (eg effectively expanding the scope of Audit and Assurance policy statements) or making it difficult for respondents to properly assess the impact of changes across companies of different sizes in the absence of legal finalisation of the definition of PIEs.

We urge the FRC to seek additional outreach and stakeholder engagement as these contemporaneous regulatory developments are completed.

Conclusion:

BDO recognise that a strong foundation of corporate governance is essential to continue growth and instil international confidence in our economy. To achieve this, improvements to the UK's existing infrastructure have to be made and as such we broadly support the suggested amendments to the code.

It is critical however that these changes are balanced and that any decisions made are done so in a way that is cognisant of their impact on some of the more overlooked members of our economy. Mid sized businesses, a vital sub section of British businesses, stand uniquely vulnerable to some of the proposed amendments and it is only right that the government are aware of this.

For our economy to continue its recovery, we need our economic engine to thrive and our recommendations within this consultation response should help them to do so.

We look forward to working with these businesses, the rest of the financial services sector and the government to ensure the governance code works for us all.

Appendix A

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

We agree that it is important to demonstrate the impact of governance practices and to go beyond a simple description of governance activities and procedures.

However, it must be recognised that not all key activities of the Board result in identifiable outcomes and indeed many are performed to ensure outcomes that could have an adverse effect on the business and its stakeholders do not arise.

To avoid unnecessarily extensive disclosures that would be burdensome to prepare and add little value to shareholders and other stakeholders, the focus should be on reporting on key outcomes that are most significant for an understanding of the governance activities and the sustainable value creation of the business. The FRC should provide additional guidance on the objective and nature of outcomes focused reporting. This could be prepared by consolidating the work the FRC has previously performed on the matter via its annual Reviews of Corporate Governance Reporting into a single explanatory and practical guide.

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 it is critically important that shareholders and other stakeholders have a clear understanding of the links between strategy, governance and climate related risks, as well as other material sustainability matters.

However, such links, at least in respect of climate-related risks, are already expressly required by the Listing Rules, through the adoption of TCFD recommendations, in a more comprehensive and integrated way. Furthermore, there are clear regulatory roadmaps to new disclosures on transition plan disclosures via the work of the Transition Plan Taskforce and to the adoption of the ISSB sustainability reporting standards that will require similar integration of broader sustainability matters. We do not believe it is helpful to provide overlapping reporting requirements via the Corporate Governance Code that could lead to duplication and confusion.

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

True stakeholder engagement requires the active involvement of both the Board/Committee members and stakeholders. Despite their best endeavours, it can sometimes be difficult for committee chairs, especially those of smaller to mid-sized companies, to persuade investors or analysts, for example, to engage.

For this reason we disagree with the change in Provision 3 of "Committee chairs should seek engagement.." to "Committee chairs should engage…". Instead, we recommend that the new requirement to report on the outcomes of engagement should include the steps taken to engage with stakeholders, even if such engagement was not forthcoming.

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?

The overall expansion of the requirements within the Code, growing responsibilities placed on directors by legislation and other regulatory requirements, and the increased focus on improving the overall quality of corporate governance will all lead to greater calls on the time and specialist skills of executive and non-executive directors. A director's ability to meet these demands and provide the necessary time and attention can be diluted if there are other competing demands from other commitments.

Therefore, we agree with the proposed change to Principle K, noting that the director's commitments to other organisations may be broader than other non-executive directorships they hold.

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?

It is not clear what is meant by the new requirement in Provision 15 that "All significant director appointments should be listed in the annual report…". Is this intended to cover all appointments, of any nature, held by the directors of the company, or only all third-company directorships they hold?

If it is the latter, this information is already publicly available via Companies House so we question the benefit of additional disclosures in the Annual Report. Furthermore, commitments to other organisations other than directorships could similarly be a significant call on a director's time.

If it is the former, we are not convinced that directors should be required to disclose personal appointments if they are not already on the public record.

If the change that is proposed to Principle K is made, such that the Board is required to assess annually whether external appointments are impinging on a director's ability to meet their responsibilities to the company, then we do not consider it necessary to also require that those external appointments be disclosed.

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

We do not consider the changes to strengthen the existing regulations in this area as compliance with those is independent of a company's compliance with the Code.

If the Code covers a matter that is included in other regulation then we agree they should be aligned, and we believe the proposed changes achieve this. In some instances, duplication may be unavoidable where a matter is dealt with elsewhere but is also fundamental to an element of corporate governance. In this case, duplication is justified as Board composition is clearly a fundamental matter for inclusion in the Code. However, as a general rule duplication should be minimised and avoided where possible.

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 support these changes.

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

We support the changes and agree, in principle, they offer a transparent approach to this reporting. However, in practice, it is unlikely to be sufficient to avoid boiler-plate and uninformative disclosures in all cases. In many cases, the quality of reporting will only be increased through regulatory oversight and/or independent assurance against a verifiable reporting framework.

9: Do you support the proposed adoption of the CGI recommendations as set out above, and are there particular areas you would like to see covered in guidance in addition to those set out by CGI?

We support the proposed adoption of the CGI recommendations.

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

We do not agree that all Code companies should prepare an Audit and Assurance Policy or provide disclosures in respect of such a policy.

The scope of these requirements has been proposed, and is shortly expected to be legally confirmed, by the government. The scope was set after extensive consultation, with consideration given to the costs and benefits of implementation across companies. We do not agree that the FRC should effectively overrule these assessments and decisions.

The purpose of the Audit and Assurance Policy is to stimulate dialogue between the company and its shareholders on the appropriate scope and form of assurance gained over information outside of the financial statements. Given smaller listed companies generally struggle to have meaningful engagement with shareholders, we would not anticipate any additional engagement arising in respect of the company's assurance service decisions.

As discussed in our covering letter, we do not believe the comply or explain principle should be relied on to ensure proportionality in this case.

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?

For those within the scope of the Minimum Standard, the proposed amendments remove unnecessary duplication. However, this is at the expense of effectively expanding the scope of the Minimum Standard beyond that recommended by the Competition and Markets Authority.

We believe the current Audit Committee requirements should be retained for those outside the scope of the Minimum Standard, while those within its scope should be referred directly to it. This would be consistent with the CMA recommendation.

As discussed in our covering letter, we do not believe the comply or explain principle should be relied on to ensure proportionality in this case.

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 that the remit of the Audit Committee should be expanded to include narrative reporting. However, the Code should clarify that this is within the context of the annual report and not

necessarily all narrative reports issued by the company, especially where such additional reporting is on matters not otherwise covered in the periodic reports.

Narrative reports are an integral part of the Annual Report and Accounts. This integration is reflected in the Listing Rules, under which directors are required to make a statement that the Annual Report, as a whole, is fair, balanced and understandable and the auditor is required to report on this statement by exception.

Given this integration, the Audit Committee remit should extend to the entire annual report.

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?

It is difficult to make a full assessment of the balance struck without any context provided by the planned revisions to the associated guidance. In particular, the notion of what constitutes a material weakness in the risk management and internal control systems will require careful consideration and further explanation in the guidance.

Materiality is commonly understood and applied in the context of financial statements – eg an error is considered material if it could affect the economic decisions made by users of the financial statements. Such assessments of materiality have been operationalised by both preparers and auditors, leading to comparable approaches and, hence, comparable information across the market.

It is less clear how an assessment of the materiality of a weakness in, for example, internal operational controls would be performed and, hence, how comparable information will be provided across the market. Clear guidance on this and other areas of the new requirements will be necessary to achieve comparability and proportionality. We return to the definition of materiality below in our response to question 17.

The development of more extensive risk management and reporting controls systems, alongside any new assurance considered necessary by Boards when making their declarations, may take time and additional resource. Given the relative limited resources of smaller companies, we urge the FRC to consider a phased approach to the introduction of the new requirements. An explanation that a company has not yet implemented such changes due to lack of resources may, in principle, be considered a valid application of “comply or explain” but, as discussed above, many stakeholders will be less understanding unless the FRC’s implementation of the Code explicitly permits a phased introduction.

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?

Risk management processes and internal control systems operate over time in response to risks that change over time. Therefore, any declaration must reflect continuous monitoring and not at any time.

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 note that references to operational and compliance controls remain and that, when taken alongside these terms, "financial controls" was commonly understood to refer to financial reporting controls relevant to the preparation of financial statements.

As discussed above, narrative reporting is an integral part of the Annual Report complementing the financial statements to provide a fuller depiction of the business, its performance, financial position, future prospects and risk exposures. Investors and other stakeholders increasingly rely on narrative information in their assessment of businesses. Therefore, we agree that references to financial controls be changed to reporting controls.

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?

Given the comprehensive scope of the reportable risk management and internal controls systems and the broad range of companies applying the Code, in respect of size, activities, sectors and organisational structures etc, the guidance should not advocate or prescribe a single framework. Not only will one-size-not-fit-all companies, but the most appropriate framework for assessing the effectiveness of operational controls may be different from that for reporting controls.

However, it would be helpful for the guidance to provide example methodologies or frameworks, as well as explaining their key characteristics for entities developing their own approaches.

Such guidance should consider the resources of and impact on smaller companies and explain clearly how proportionality could be applied.

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?

While we do not have solutions, we recognise that the development of clear and operational definitions of effectiveness and materiality, especially in respect of non-reporting controls and risk management is far from straightforward. Despite this, guidance on such definitions is fundamental to the success of these Code changes.

There are commonly understood definitions of materiality and material weaknesses applied in the auditing profession, but only in respect of financial reporting and associated controls. It is important that, if the FRC guidance applies these terms in relation to financial reporting, it does so after due consideration of how they are currently used by auditors in their communications with Board and Audit Committees. It would be confusing to users if different conclusions were met on the effectiveness of the same controls by the directors and the company's auditors due to conflicting uses of the same terms.

On the other hand, the weaknesses that are currently reported to Board's might not be considered to be of sufficient significance for reporting in the Annual Report.

Extending these definitions to narrative reporting is currently a contentious matter internationally. While the ISSB uses materiality in respect of sustainability reporting in a manner consistent with financial reporting (ie by reference to the economic decisions of users), alternative approaches are advocated by the Global Reporting Initiative and have been applied in the development of European Sustainability Reporting Standards ("ESRS"). ESRS requires a dual materiality approach to consider not only the impact on the company (and hence its investors) but also the impact of the company on the environment and wider stakeholders.

We advocate focussing on the impact of the company consistent with the ISSB approach.

It is less clear how materiality and effectiveness of controls can be extended to operational and compliance controls. Both narrative and financial reporting provides information – and materiality and effectiveness is assessed by reference to the quality of that information and the extent to which it faithfully represents what it purports to. Operational and compliance controls do not relate to the provision of information, and hence their effectiveness is less objectively measurable.

Furthermore, the acceptable risk of misstatements in reporting is very different from the acceptable risks a company must face if it is to grow and be profitable. Managed risk-taking is at the heart of every business and some failures are inevitable – it is not clear that each failure is a result of a risk management weakness rather than the necessary ups-and-downs of business in a competitive environment.

We believe these are difficult issues to resolve but must be resolved before the proposed changes are implemented. The success of implementing these changes, including the comparability of reporting outcomes, users' understanding of Board declarations and proportionality all depend on their resolution.

We therefore urge the FRC to progress slowly and carefully towards implementation, focussing on developing guidance after extensive consultation and thought.

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

No further areas are this stage but we look forward to providing assistance to the FRC as it embarks on the development of this important guidance.

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)?

Current Provision 30 is consistent with disclosures that are required by financial reporting standards so could, in theory, be deleted. However, should the new legal requirements for PIE companies also be consistent we would not oppose retaining this requirement as proposed.

Incidentally, it would be a matter of great concern if the new legal requirements were not consistent with disclosures currently required by financial reporting standards. There are common misconceptions on the use of the going concern basis of accounting viz-a-viz a company being a going concern which could be exacerbated if the new legally required disclosures differ in their terminology.

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.

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?

For non-PIE Code companies, we agree with the proposed simplifying revisions to Provision 31 (proposed Provision 32). However, in our view, proposed footnote 14 is confusing to the extent it applies to such companies. The second sentence of the footnote states:

> *For* [non-PIE Code companies] *the Board should report in a similar and proportionate way* [to the new legal requirements applying to PIEs] *or set out the basis for the assessment in the annual report.* [underlining added]

First, it is not clear what is meant by a similar and proportionate way – either the report is done in a similar way by complying with the legal disclosure requirements or it is not. It is not clear how the legal requirements could be met but only proportionately.

Second, it is not clear why non-PIE Code companies are being directed to the legal requirements, whether met fully or proportionately, and also offered the opportunity to assess in some other way if that basis is set out in the annual report.

We recommend that proposed Provision 32 be extended to include a requirement for all Code companies to set out the basis for their assessment, which for PIEs would be in accordance with the new Resilience Statement as set out in the first sentence of footnote 14. The second sentence could then be deleted.

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

We support the strengthening of the links between remuneration policy and broader corporate performance and strategy as proposed.

However, it must be recognised that, for some companies, they may not have formal objectives for some sustainability (or ESG) matters or such objectives may not be sufficiently material to the successful delivery of the company's long-term strategy for them to be referenced in remuneration policies. The FRC should clarify that the "alignment" envisaged by new Principle P can encompass high level alignment rather than detailed links between remuneration and specified quantifiable objectives in all areas.

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

For many companies, malus and clawback provisions are already clearly explained in remuneration policy disclosures. However, we do agree that the proposed reporting changes will improve comparability of disclosures and greater transparency overall.

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

We generally agree with the proposed changes to (former) Provisions 40 and 41 as they will improve the clarity and usefulness of the required disclosures.

However, and consistent with our response to question 22 above, the FRC should clarify that the "support" of ESG objectives does not require ESG metrics to be specifically referenced in the remuneration policy or be determinative of remuneration levels. As noted above, not all companies will have material and quantifiable ESG metrics as such matters may not always be material to the delivery of long-term strategic objectives or value creation.

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

As noted above, unnecessary duplication in the Code of matters already dealt with effectively in other reporting requirements should be avoided. For this reason, we support the removal of pay gap any pay ratio disclosures from the Code.

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?

No comment.