IoD CENTRE FOR CORPORATE GOVERNANCE PAPER

UK Corporate Governance Code
What changes have been proposed and do they go far enough?

Key points from a webinar discussion
26 July 2023

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Introduction

It has been five years since the Financial Reporting Council (FRC) last overhauled the UK Corporate Governance Code. Since then (2018), a series of corporate scandals at companies including retailer BHS, outsourcer Carillion and café chain, Patisserie Valerie, have ramped up calls for stricter controls on risk management and for more transparency in the decision-making process at top companies.

Those devastating collapses prompted a 2021 government consultation to shake-up the audit and corporate governance regimes. Ministers have decided not to legislate on some of the more contentious issues, opting instead for the more business friendly approach of overhauling the Corporate Governance Code.

The FRC (which oversees the Code) has responded with plans, aimed at increasing boards' responsibility for accurate accounts and strengthening board accountability for misconduct, including measures to clawback directors' remuneration in the event of misconduct or other serious failings.

As a result, under the revised Code companies would be expected to include such provisions in directors' employment contracts.

Companies would also be expected to disclose in annual reports the "minimum circumstances" in which these provisions could be triggered and whether they have been used in the most recent financial year. Revisions to the Code are open to public consultation until mid-September and will come into force from 1 January 2025.

The Code applies directly to companies with a premium London listing and board directors can choose not to comply so long as they explain their reasons.

Many of the new recommendations in the Code will also be relevant to large unlisted companies falling within the definition of a Public Interest Entity (businesses with more than 750 employees and a turnover of more than £750 million). In the future, all such companies (listed and unlisted) will have to publish a Resilience Statement setting out their approach to risk management. It should also be noted that the Code is often used as a reference point for organisations of all kinds as it is seen as an exemplar to aspire to, even for relatively small businesses.

On 26 July 2023, the IoD hosted a webinar - UK Corporate Governance Code: what changes have been proposed and do they go far enough?

We look here at some of the key changes to the Code and what our expert panel had to say about it.

Internal controls

One new requirement makes a nod towards to the US Sarbanes-Oxley Act, passed in 2002 following the Enron accounting scandal, whereby directors must make a declaration that their companies' internal controls have been effective and subjected to external assurance.

In July 2023, David Styles, FRC director of corporate governance and stewardship, told the Financial Times that including internal controls rules in the Code, rather than putting it in legislation, "makes clear the board's accountability for this issue, yet reflects the need for flexibility, proportionality and consideration of the particular circumstances of individual companies". Also, it will not be mandatory for firms to obtain an external assurance of these controls from an accounting firm.

Paul Lee, head of stewardship and sustainable investment strategy at Redington, the investment consultant, told our webinar that he was 'very comfortable' with this more flexible approach. He noted that Sarbanes-Oxley imposed huge additional expense on US companies when it was introduced. He said:

If we can avoid that burden on every company, that would seem wise. I do think that some companies would benefit from it [i.e. external assurance] - you can see that some auditors don't have confidence in the internal controls of some companies. But it should be chosen [by companies] and not for every company.

Chris Hodge, senior adviser to the IoD Centre for Corporate Governance and a former head of corporate governance at the FRC, welcomed the Code's stronger focus on internal controls, saying:

My experience is that reporting on controls has been a longstanding weakness. In the days when I used to review this, so many companies would submit bland assertions that everything worked well.

Given the size and complexity of some of these companies that's frankly implausible. So a bit more rigour on this is a welcome thing.

Material weakness

One of the more contentious revisions to the Code is the expectation that directors disclose “material weaknesses or failures” in these controls – both in the previous accounting period and currently.

This has sparked concern in boardrooms about whether this is realistic. Hodge said that during his time at the FRC, companies wouldn’t disclose these hiccups and shortcomings because it might spook investors and destroy company value. He said:

The view from investors used to be the company would have more credibility if the board said ‘we’re on this, we’ve dealt with it’, rather than just blandly asserting that everything is fine.

Lee added:

I strongly agree. Companies do themselves a disservice by failing to talk about issues that have been spotted and dealt with. Investors don’t need to know the absolute detail, just that it’s been dealt with.

Audit and ESG

Another issue that has sent tremors through boardrooms is the proposal to place additional responsibilities on audit committees to report on environmental, social and governance issues.

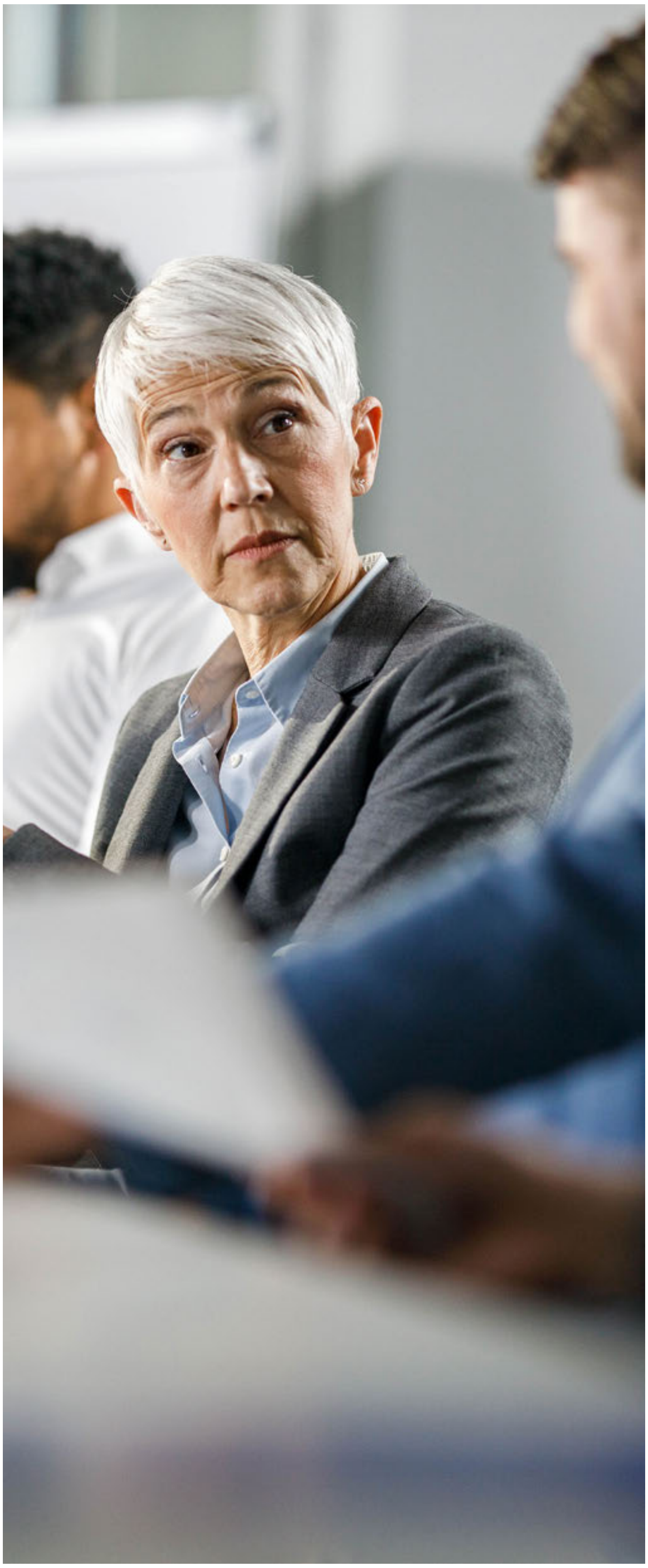
The revised Code would require companies to have an audit and assurance policy outlining how they seek external assurance over their internal controls on the ESG metrics published in annual reports.

Hodge spoke for many directors when he asked whether the audit committee has the capacity to take on this job. He said:

The job of the audit committee is going to get way more busy and more complicated. I do have some reservations about the policy, mainly because the role of the audit committee is already big and it's getting bigger... Is there a risk that sustainability reporting might be overlooked as a result?

Jessica Dahlstrom, senior manager for corporate governance at the FRC, agreed that there are a huge number of ESG rules, and noted that an increasing number of 'green' reporting requirements are being placed on boards. However, she said:

We tried not to introduce any new requirements. We are hoping to tie up some of the confusion by giving one governance body oversight of all that reporting.



Board review

The Code is changing the terminology around board evaluations. It now proposes to call them 'board performance reviews'. On the surface, it seems like a minor change. It is something of direct interest to the IoD, which offers 'board performance reviews' to a wide variety of organisations.

Hodge was a member of the Chartered Governance Institute team that was asked by the government to report on this a few years ago. He said it was clear there was a 'misunderstanding' about the terminology. He said:

> **There was an expectation that it would act as a backward-looking form of assurance that everything was fine with the company. The intention is that it's one of continuous improvement for boards. One of the recommendations of the report was to change the terminology [to review]. So, I would support that change.**

Conclusion

With even greater responsibility being placed on boards, directors are concerned that the changes may be placing more of a focus on conformance rather than performance. It also raises some questions about when directors will find the time or the headspace to discuss strategy and innovation.

Hodge has some concerns in this area, noting that the proposed changes require boards to take greater account, and be more transparent, about internal controls in general - not just financial, but also operational.
He concluded:

> **It will make it more challenging for boards because there are more variables to look at.**

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The Institute of Directors is a non-party political organisation, founded in 1903, with approximately 20,000 members. Membership includes directors from right across the business spectrum – from media to manufacturing, professional services to the public and voluntary sectors. Members include CEOs of large corporations as well as entrepreneurial directors of start-up companies.

The IoD was granted a Royal Charter in 1906, instructing it to “represent the interests of members and of the business community to government and in the public arena, and to encourage and foster a climate favourable to entrepreneurial activity and wealth creation.”

The Charter also tasks the Institute with promoting “for the public benefit high levels of skill, knowledge, professional competence and integrity on the part of directors”, which the IoD seeks to achieve through its training courses and publications on corporate governance.

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