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FRC proposes changes to the UK Corporate Governance Code

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On 24 May 2023, the Financial Reporting Council (FRC) launched a public consultation on proposed revisions to the current version of the UK Corporate Governance Code (the Code). These revisions focus on the legislative and governance reforms – supporting the transition of regulatory oversight of audit and governance from the FRC to the Audit, Reporting and Governance Authority (ARGA) – set out by the UK government in "Restoring Trust in Audit and Corporate Governance" published in May 2022.

The proposed revisions aim to enhance the Code's effectiveness in promoting good corporate governance and include, amongst other things, the following changes:

Section 1 - Board leadership and company purpose

- **Reporting on governance activity (new Principle D):** the FRC proposes to introduce a new Principle setting out the expectation that companies should, when reporting on their governance activity, focus on activities and outcomes to demonstrate the impact of governance practices and how the Code has been applied. The FRC noted that reporting has been lacking in this respect and that this new Principle should encourage companies to make greater progress in this area and assist them in better meeting the needs and expectations of their stakeholders.
- **Reporting on environmental and social matters in the context of company strategy (new Provision 1) and engagement with shareholders (new Provision 3):** the FRC proposes to make revisions to Provision 1 and Provision 3, to require companies to report on how environmental and social matters are taken into account in the delivery of its strategy (including its climate ambitions and transition planning) and on the outcomes of engagement with their shareholders, which has taken place during the reporting period.

Section 2 – Division of responsibilities

- **Enhanced reporting on commitments of directors (new Provision 15) and board evaluation process (new Principle K):** the FRC proposes to supplement Provision 15, to require companies to list in their annual reports all significant director appointments and to describe how each director has sufficient time to undertake their role effectively, in light of commitments to other organisations. The proposed revision would not only require setting out board positions of each director, but also their committee roles and the potential number of commitments each year. Linked to this, a new Principle K would require the annual board performance review to consider each director's commitments to other organisations, and their ability to discharge their responsibilities effectively. The

FRC welcomes views on whether this increased transparency and evaluation might have a positive impact on how directors determine that they have sufficient time available for their roles.

Section 3 – Composition, succession and evaluation

- **Enhanced focus on diversity and inclusion (new Principle I):** the FRC proposes to revise Principle I to include a reference to inclusion, and to give equal weight to all protected and non-protected characteristics, to encourage companies to consider diversity beyond gender and ethnicity. The FRC's proposed revisions are intended to strengthen the Code in this area to support the wider regulatory framework, without introducing additional, duplicative targets or regulations.
- **Enhanced requirement on external board performance review (new Provision 22):** the FRC proposes to revise Provision 22 by emphasising that company Chairs *should* commission (rather than consider having) a regular externally facilitated board performance review.
- **Enhanced reporting on the work of the nomination committee (new Provision 24):** the FRC proposes to supplement Provision 24 with additional reporting requirements with respect to the work of the nomination committee, in order to provide improved clarity on the approach to succession planning, board and senior management appointments and the effectiveness of the diversity and inclusion policy. The FRC notes that annual reviews continue to identify poor reporting on the approach to succession plans, with reporting in most cases suggesting that succession arrangements are reactive, rather than proactive.

Section 4 – Audit, risk and internal control

- **Enhanced board accountability for a company's risk management and internal control framework (new Principle N):** the FRC proposes to revise Principle N to provide that boards should not only establish but also *maintain* an effective risk management and internal control framework, with a view to enhancing their accountability for the framework.
- **Additional responsibilities of the audit committee (new Provision 26) and enhanced reporting on the work conducted by the committee (new Provision 27):** the FRC proposes to supplement Provision 26 with additional responsibilities of the audit committee and to enhance the annual reporting requirements in Provision 27, by aligning them with the additional responsibilities. The proposed additional responsibilities include (amongst other): (i) responsibility for monitoring the integrity of narrative reporting (including sustainability matters); (ii) developing, implementing and maintaining the audit and assurance policy (AAP); (iii) following the Audit Committees and the External Audit: Minimum Standard; and (iv) promoting effective competition during the tendering for an external auditor in order to support audit market diversity. The proposed revisions to the Code would have the effect of requiring *all* Code companies to prepare an AAP, on a "comply or explain" basis, going over and above the requirements of the expected draft legislation on the AAP, which is expected to only require public interest entities (PIEs) – UK public and private companies which have 750 or more employees and a turnover of £750 million or more – to produce an AAP.
- **Enhanced reporting on risk management and internal control systems (new Provision 30):** the FRC proposes to supplement Provision 30 with enhanced reporting requirements on a company's risk management and internal control systems, including the requirement for the board to give: (i) a declaration of whether it can reasonably conclude that the company's risk management and internal control systems have been effective throughout the reporting period up to the date of the annual report; (ii) an explanation of the basis of its declaration (including how it has monitored and reviewed the effectiveness of these systems); and (iii) a description of any material weaknesses or failures identified and the remedial action being taken. The objective of the proposed approach is to avoid a situation where the review of effectiveness of risk management and internal control systems is seen as a

one-off exercise that assesses the effectiveness of a company's systems at one point in time.

- **Revised viability statement to align with the anticipated statutory Resilience Statement (new Provision 32):** the FRC proposes to revise Provision 32, to ask boards to explain in their annual report how they have assessed the future prospects of the company, including its ability to meet its liabilities as they fall due over the period of their assessment, drawing attention to any qualifications or assumptions as necessary. Companies that have complied with the statutory Resilience Statement (which is expected to apply to PIEs only), will be compliant with this Provision and changes have therefore been made to the Code to avoid duplication. For Code companies that will not be subject to the statutory Resilience Statement, the board should report in a similar and proportionate way to the statutory requirement or set out the basis for the assessment in the annual report.

Section 5 – Remuneration

- **Strengthening links to overall corporate performance (new Principles O-Q):** the FRC proposes to amend the Principles to bolster the links between companies' remuneration policies and corporate performance in the broader sense. The new Principle P highlights the importance of aligning remuneration outcomes with company performance, purpose and values, and now includes a reference to ESG objectives. Workforce pay and conditions are now also specifically addressed in the new Principle Q as a relevant circumstance in determining remuneration outcomes.
- **Increasing transparency in reporting on malus and clawback provisions (new Provision 40):** the FRC proposes a new Provision 40, which sets out a requirement for additional information on malus and clawback provisions to be included in companies' remuneration reports. This includes a statement on whether the company has malus and clawback arrangements in place, the minimum circumstances in which they could be used, the minimum period for their application (along with an explanation of why this period is best suited to the organisation) and any use of the provisions in the last five years. The aim is to provide investors with greater transparency and consistency.
- **Improving the quality of reporting on the work of remuneration committees (new Provision 34):** the current Provision 40 includes a list of factors remuneration committees should address in setting executive remuneration. The FRC notes (citing research it had commissioned in 2021) that many companies provide brief and generic information on each factor. The FRC proposes to delete Provision 40 and incorporate some of its provisions elsewhere to enable reporting in a way which is specific to a company's own circumstances. The FRC also proposes to remove the reference to reporting on pay gaps given the increased access to gender pay gap reports on company websites.

Consultation deadline and anticipated effective date

The consultation runs until 13 September 2023, with the current expectation that the revised Code will apply to accounting years commencing on or after 1 January 2025. The FRC is expected to update its guidance to supplement the revised Code in due course.

If you have any questions regarding the matters covered in this publication, please reach out to any of the lawyers listed below or your usual Davis Polk contact.

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