

UK Corporate Governance Code and Guidance on Board Effectiveness: Comments and Response to Questions

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Comments from ACCA to the Financial Reporting Council

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ACCA welcomes the opportunity to comment on the proposed changes to the UK Corporate Governance Code (the Code) and Guidance on Board Effectiveness (the Guidance), issued by the Financial Reporting Council.

OVERALL COMMENTS

ACCA welcomes the move to ‘shorten and sharpen’ the Code

ACCA supports the FRC’s endeavour to keep the Code a principles-based document. We note that the Code has addressed successfully a number of corporate governance issues in a non-legislative manner over the last 25 years. This has however caused the Code to lose its original clarity and consistency. We welcome the revised Code as a starting point to addressing ratifying this issue by removing details to specific guidance, but also put forward some additional suggestions for improvement throughout our response below.

Shortening the Code will enable the principle requirements to be clearer than the previous version, simply supported by ‘comply or explain’ provisions. We support eliminating the ‘supporting principles’; the status of which within the Code has always been ambiguous.

We also support including references to other guidance on issues such as board effectiveness and the audit committee. This would enable the Code to remain focused on the core principles, while also signposting specific practical guidance resources for those who need it.

ACCA supports the FRC’s proposal to remove some exemptions currently allowed for smaller listed companies. If the Code successfully stays true to being a principles-based, outcome-oriented document that promotes a high standard in corporate governance then it will continue to meet its purpose and also mitigate the risk of potential multiplication of corporate governance codes in the UK.

ACCA believes that a principles-based Code can function as a framework document to be used by all sectors and organisations, appropriately complimented by specific guidance where required. This current activity in revision is a great opportunity to achieve this.

Leaders are responsible for corporate culture

We are also pleased that the FRC has reflected in the proposed revised Code some of the key findings from its work on culture. The FRC’s work, alongside ACCA’s own work on culture, indicates that the expectation for corporate governance and corporate leadership has changed: building healthy and robust corporate culture is a task for leaders the Code must address this.

The role of the board is broader than wealth maximisation

Furthermore, ACCA believes that the role of boards is not merely to maximise a company’s wealth by way of efficient use of its resources: best performing companies

bring together their internal and external stakeholders to align with their purpose and create optimal value in the long run.

The Code should focus on outcomes over procedures

The focus of governance is moving from mere compliance to processes and procedures to the effect of applying them; and towards a focus on the role of all the people – not just the board but also the workforce – in delivering the long-term success of business.

Therefore the Code must clearly state the intended outcomes. It does not need to prescribe to the level of specific actions and details – it is up to each company in each situation to decide these. The Code is there to set the expected outcome that companies should achieve via such action. The Code's 'apply and explain' approach is certainly a step in the right direction.

However, the Code could go further here. In addition to explaining the intended outcomes, the Code should require companies to take responsibility for identifying the specific measures that will best achieve that. This will prevent companies from 'box ticking' lone provisions, and instead force them to consider how they have (or have not) achieved the intended outcome.

The proposed guidance mentions the importance of applying principles rather than merely complying with provisions. ACCA believes that this could also be further emphasised. Compliance to principles requires companies to show evidence that they've conducted specific activities, while application requires them to demonstrate that the activities they have undertaken have had the intended effect. Essentially, application requires companies to embrace the intended outcome of corporate governance requirements and therefore encourages a more meaningful exercise.

What matters is not simply what companies have done, but more so what they have achieved by doing it. The role of the Code here is to clearly articulate intended outcomes – which are overarching and do not change from company to company. If the Code takes this focus, rather than looking at too many example-based proposed measures and procedures, it will be shorter, sharper and more principles-based – as the FRC intends.

AREAS FOR SPECIFIC COMMENT:

Application of the Code

Q1. Do you have any concerns in relation to the proposed Code application date?

We do not have a concern in relation to the proposed Code application date.

Guidance

As stated in the overall comments, ACCA supports the revision to the Guidance on Board Effectiveness (hereafter, Guidance) and the FRC's decision to move detailed explanations from the Code to Guidance. Questions for the board should be a useful aide for the boardroom discussion.

The structure of the Guidance being aligned to the Code is helpful. This however leaves areas of the Code to stand out where no further guidance is available because the Code itself is shorter. In areas where we considered more guidance may be useful, we have commented in the rest of our response.

Q2. Do you have any comments on the revised Guidance?

We have commented on the Guidance as applicable across this response.

Section 1 - Leadership and purpose

We welcome that the Principles collectively address board accountability for the long-term success of the company. We also note the addition of the word 'sustainable'. This links to the long-term viability but is a broader concept and, in our view, takes into account the wider environment by implication and better reflects today's thinking on governance. We support the inclusion of the word.

At a cursory glance, Principle B appears obvious, discussing the responsibility of the board in relation to the necessary resources that must be made available for the running of the company and measuring performance. However, we noted the term 'ensure', which links more to execution rather than oversight. While we welcome the substance of the principle, the FRC may consider substituting the term with 'oversee' or similar in the principle, explaining how this may differ from the role of the executives in the Guidance.

Wider stakeholders

ACCA supports the overall message and drafting of Section 1 Principles. Board responsibility over culture did not much feature in corporate governance debate until recently. ACCA believes that the combined effort of those who cooperated in the Culture Coalition as well as our own work on culture (<http://www.accaglobal.com/uk/en/professional-insights/risk/acca-culture-governance-tool.html>) has contributed to the trend change.

A well-functioning company should have a healthy corporate culture which brings together the workforce around its purpose, maximising the value from human as well as other material resources. To achieve this, however requires a strong commitment from the board to lead, support and closely monitor relevant actions.

The board needs to be cognisant that the process of building a healthy culture is two-way. It requires effective channels of communication from the rest of the organisation - not just from the top down - in place to enable the board to assess the effectiveness of the communication of their message on the corporate culture. Companies should also be able to explain the mechanisms they have in place to facilitate this bottom-up communication, and Provision 2 should refer to the need to monitor the outcome of the board's action.

Q3. Do you agree that the proposed methods in Provision 3 are sufficient to achieve meaningful engagement?

Provision 3 sets out the need to gather the views of the workforce. To achieve this, the provision requires the adoption of one of three 'normal' methods.

While ACCA appreciate that a request from Government prompted the consultation on this point, we do not believe that requiring companies to adopt one of these methods is the best way forward. As we have discussed in the overall comments, it is important to emphasise what the Code intends to achieve, not to describe specific methods that may or may not work in individual circumstances.

Specifically, the first part of Provision 3 refers to the need of gathering the views of the workforce. However, this falls short of explaining why this is desirable: in our view, it is because this can help the company gauge how effectively it has communicated its purpose, strategy and values to its workforce and how well its corporate culture is aligned to them. It is fundamentally down to companies as to how they have addressed the objective provided that they have achieved the intended outcome and they can account for how they have done so.

Proposed methods are examples that have been used and illustrated in the Government Green Paper and some companies may decide to adopt one. But the Code should be clear about this in Provision 3 as in the Guidance, and give flexibility as set out in the previous paragraph: otherwise we fear that the Code risks reducing the good intention to a tick-box exercise.

ACCA would like to emphasise that the board is not a collective of individual directors representing different groups or interests. It is a body of directors with different skillsets and viewpoints to enable robust decision making, unified for the benefit of company's long term success.

Q4. Do you consider that we should include more specific reference to the UN SDGs or other NGO principles, either in the Code or in the Guidance?

ACCA supports the proposed approach to the frameworks on stakeholder engagement disclosure. It will be helpful to the users to be referred to more robust frameworks where appropriate. However, relevant frameworks will evolve and be updated over time. Therefore, the FRC should refer to specific frameworks as part of the Guidance but not in the Code.

Workforce definition

ACCA supports the definition.

We also welcome that Paragraph 31 of the Guidance refers to the notion of workforce that extends beyond the employees, and that agency workers and contractors should be included in engagement mechanisms where appropriate.

Shareholder engagement

Shareholders play a fundamental and important role in corporate governance.

We support the disclosure requirements in Provision 6. It should encourage companies to better engage shareholders and also encourage companies to clarify how they will extend the corporate culture to all stakeholders. It would, at the same time, highlight any gap in the way they engage different stakeholders.

Q5. Do you agree that 20 per cent is 'significant' and that an update should be published no later than six months after the vote?

20% thresholds appear reasonable: considering that this would amount to 34 per cent of votes against resolutions held at FTSE 350 in 2017 (2016: 19 per cent), this captures the shareholder sentiment as widely perceived during the period.

The requirement to publish an update within six months appears to be reasonable. This will encourage companies to bring forward the timing of their engagement with shareholders following the voting results and allow more time for considering and taking subsequent actions.

Culture

ACCA supports the change as noted under overall comments.

Whistleblowing

ACCA is pleased to see the prominence given to the need for internal speak-up arrangements in Principle D and Provision 3. ACCA strongly supports the need for robust speak-up arrangements as this can help foil criminal and illegal activities and also help companies defend themselves from reputation damages.

ACCA encourages the FRC to discuss this topic separately from workforce engagement. These areas have different purposes although both are related to culture, and deserve two separate provisions. ACCA would support explicit reference to 'speak-up' or 'internal whistleblowing' to give legitimacy and a profile to this important process.

ACCA also considers that the board guarantee of whistleblower anonymity is of paramount importance for effectiveness of speak up arrangements. The relevant wording, in a separate provision, should be revised as:

The board should be directly responsible for the effectiveness of speak-up arrangements ~~There should also be a means~~ which allow the workforce to raise concerns in confidence and ~~(if they wish)~~ anonymously. The board should review this **regularly** and ensure that arrangements are in place for the proportionate and independent investigation of such matters and for follow-up action.

We believe that the Guidance should have further practical measures to help companies raise the standard in this area. ACCA's publication *Effective Speak up arrangements for whistleblowers* (<http://www.accaglobal.com/gb/en/professional-insights/risk/speak-up-arrangements-whistleblowers.html>) is a comprehensive and useful document for companies to understand how to maximize the value of internal speak-up channels. We will be delighted to assist the FRC in developing relevant paragraphs for the Guidance.

Section 2 – Division of responsibilities

Principle G refers to the recommendations first promoted in the Higgs report of 2003. ACCA suggests a small tweak in the wording 'holding management to account': it might be better phrased as 'holding **senior** management **including executive directors** to account' to reflect the relationship between the board and senior management as it is unlikely for them to be directly interacting with management.

Board composition

ACCA recognises the importance of the chair and their responsibility for the board's overall effectiveness.

Principle E has shifted the focus of the functional role of the chair as the leader within the board to include emphasis on the relationship between the board and the company. We consider this to be a useful reminder of the overall role of the board.

Q6. Do you agree with the removal of the exemption for companies below the FTSE 350 to have an independent board evaluation every three years? If not, please provide information relating to the potential costs and other burdens involved.

ACCA supports the FRC's decision to remove the exemption for companies below the FTSE 350. We are of the view that the evaluation of board effectiveness has benefited boards of companies (and non-companies) of all sizes. Provided that the Code allows a degree of flexibility in how companies may meet the purpose, it should promote the highest standard of corporate governance.

However, ACCA firmly believes that the external facilitator should be independent from the company or individual directors to ensure that the board evaluation is effective. Disturbingly, Provision 21 which discusses the annual evaluation of board performance seems to permit external facilitator who may have connection with the company or individual directors.

ACCA considers that this is a fundamental weakness that undermines the value of such evaluation. A potential conflict of interest may occur or be perceived as such if a board engages, for example, the statutory auditors or the executive search firm. The requirement to disclose any connection that the facilitator may have with the company or individual directors is unlikely to be effective given that the lack of independence at the time of evaluation cannot be addressed by subsequent disclosure.

Accordingly, the FRC may consider deleting some of wording from Provision 21 as below:

21. There should be a formal and rigorous annual evaluation on the performance of the board, the chair and individual directors. Companies should have an externally facilitated, **independent** board evaluation at least every three years. The external facilitator should be identified in the annual report ~~and a statement~~

~~made as to whether they have any other connection with the company or individual directors.~~

Independence and tenure

Q7. Do you agree that nine years, as applied to non-executive directors and chairs, is an appropriate time period to be considered independent?

There is insufficient discussion as to what the FRC means by independence and what benefits an independent board member should bring to the boardroom discussion. We believe that Principle G may usefully refer to independence as to explain the basis of constructive challenge by, for example, rewording as below

G. Non-executive directors should provide constructive challenge, strategic guidance, offer specialist advice and hold management to account based on their expertise and, in the case of independent non-executives, independence.

As drafted, the Code appears to focus overly on the procedures of determining individuals' independence in Provision 15.

Judgement as to independence is not something that rules can guarantee: it is a matter of mind-set and relationship which may be affected by the relationships between senior management and board members as well as within the board.

For example, the nine-year rule (the ultimate bullet point, Provision 15) may be one parameter in assessing individual directors' independence but we are not convinced that this can automatically guarantee or rebut independence. Furthermore, board member evaluation by an independent external party may also provide a rigorous procedure that can be used alongside the nine-year rule, albeit it is more complex and potentially costlier.

In terms of tenure, the Code does not permit non-executive directors to be considered independent, and in the case of the chair, to remain in the position. If the prevalent practice is that companies consider directors to be no longer independent by 'de facto', the Code should allow exceptions where appropriate. We are supportive, however, of the introduction of rigorous scrutiny in determining their independence.

Section 3 – Composition, succession and evaluation

Q9. Do you agree that the overall changes proposed in Section 3 of revised Code will lead to more action to build diversity in the boardroom, in the executive pipeline and in the company as a whole?

Q10. Do you agree with extending the Hampton-Alexander recommendation beyond the FTSE 350? If not, please provide information relating to the potential costs and other burdens involved.

Q11. What are your views on encouraging companies to report on levels of ethnicity in executive pipelines? Please provide information relating to the practical implications, potential costs and other burdens involved, and to which companies it should apply.

The debate around diversity has progressed in recent years. ACCA is pleased with Principles J and K that gives necessary emphasis to diversity.

However, we do not think that the Provisions give sufficient discussion as to what diversity means in the boardroom and its intended effect in terms of good governance. The current wording says no more than the importance of the diversity alongside the balance of skills, experience, independence and knowledge.

On one hand, board diversity is about having companies perform better by making them explore diverse risks and opportunities fully via rigorous discussion in the board room. On the other hand, there is another driver of diversity that concerns the society we live in. Our society is diverse, and if the boardroom doesn't reflect this, we must ask ourselves why this is the case.

In our view, it is important not to excessively focus on the quality of discussion in the boardroom or business performance as the sole drivers for diversity. There are multiple factors that contribute to these matters. Furthermore, the objective of diversity is not solely to improve the bottom line in the short term. Therefore we do not consider it necessary to prove the causal relationship between diversity and operational and functional indicators.

We recognise that diversity is also about recognising and improving social mobility: we would like to see our society providing opportunity for all and enabling progression (which is also an integral part of ACCA's mission). If boardroom or executive teams are not diverse, this implies that the company is not reaching broadly to identify a sufficient pool of talent sources or not nurturing its pipeline for its workforce to progress. A diverse board is better able to understand and incorporate the needs and views of a much wider range of stakeholders in the decision-making process. Diversity therefore links back to corporate culture which we discussed earlier in this response.

ACCA believes that company disclosures should include measurable targets which can be reviewed and revised by companies' and organisations' own accord, over and beyond government-driven targets. In terms of other diversity criteria such as ethnicity and socio-economic background, we should encourage companies to consider and explain their rationale as to how they are addressing them and in what order of priority as well as target figures.

Section 4 – Audit, risk and internal control

Q12. Do you agree with retaining the requirements included in the current Code, even though there is some duplication with the Listing Rules, the Disclosure and Transparency Rules or Companies Act?

We do not see duplicating requirements as an issue as such. The issue is the lack of clear referencing as to where duplication exists, and any differences between requirements that appear duplicated (but are actually not).

Audit committees

ACCA notes that there is no fundamental change to the requirements related to audit committees. We would like to draw your attention to findings of a recent ACCA research report on the factors that contribute to a quality audit (*Tenets of a quality audit*, <http://www.accaglobal.com/uk/en/professional-insights/global-profession/Tenets-of-quality-audit.html>). It identifies that some of these factors can be in tension – audit committees would benefit from a greater level of awareness of this subject.

ACCA will also share some relevant research into key audit matters, which identifies that their disclosure in the audit report has a consequential positive impact on how the audit committee fulfils its function. This report will be available in March 2018 and shared separately.

Q13. Do you support the removal to the Guidance of the requirement currently retained in C.3.3 of the current Code? If not, please give reasons.

We agree with the removal of the list of the main roles and responsibilities of the audit committee to the Guidance. This aligns with other changes introduced to the Code.

Risk and internal controls

We consider that Principles are set at the right level, but it would do no harm referring to the audit committee. Related Provisions' focus seems to centre around the description of processes and procedures rather than the relationship of the board with the audit committee and its delegated authority. We recommend that the balance should be reversed.

The same applies to a degree to the Guidance, particularly around the viability statements. However, this is expected from the Guidance because of its positioning.

Section 5 – Remuneration

Q14. Do you agree with the wider remit for the remuneration committee and what are your views on the most effective way to discharge this new responsibility, and how might this operate in practice?

Q15. Can you suggest other ways in which the Code could support executive remuneration that drives long-term sustainable performance?

Q16. Do you think the changes proposed will give meaningful impetus to boards in exercising discretion?

Overall, we are satisfied with the Principles. Principle P should refer to the importance of communication, not just transparency, as communication is about the messaging and

accountability that contributes to building a healthy corporate culture. We believe this is the underlying message of Principle O.

In recent years, efforts to link executive pay with performance have had success, but with diminishing returns with regard to stemming the upward trend in executive pay. This increases the importance of each company's messaging around its executive pay to internal and external stakeholders. Where the board lacks a desire to communicate the thinking behind executive pay versus rewards to the workforce, the company will find it difficult to nurture a healthy corporate culture.

In our view, more work is necessary to identify the other factors that contribute to the upward trend in executive pay and to explore potential solutions. ACCA looks forward to working more with the FRC and others in this area.

UK STEWARDSHIP CODE QUESTIONS

Since its release in 2010, the Stewardship Code has become widely recognised as an authentic good practice source for investor stewardship in the UK. Its variations have been developed globally and this is a sign of its success.

The FRC's exercise to introduce tiers in 2016 was, in our view, broadly welcomed by investors and the subsequent removal of tier 3 was a positive step in demonstrating that stewardship reporting is intended to enhance accountability of investors and not just a matter of exhibiting a report of limited value.

During these years, the landscape of investment has also changed. Significance of investors' role in the wider economy is widely understood. Ultimate beneficiaries including the public at large expect them to play an active role in contributing to the continued prosperity and sustainability of wider society.

The Stewardship Code has the potential to play an important role by setting out this rationale and holding investors accountable. In order for this to happen, there are several key issues to be consulted on and we set them out below. We have also provided some references to the consultation questions to which they may relate to (NB: not all questions are covered):

- Emphasising the role of investors within wider society: This is incorporated in Principle A of the Code. The FRC may wish to consult whether this should be introduced into the Stewardship Code explicitly. (Q20, Q21, Q22)
- Extending the applicability of the Stewardship Code across the investment chain: This may involve exploring (i) the structure of the Stewardship Code: eg whether to keep the document principles-based and supplement it with guidance addressed to different categories, develop a full document that contain various exemptions, or separate codes; and (ii) the mechanism of enforcement: eg all are to sign up to the relevant Stewardship Code or organisations report to those who are next up at the investment chain. (Q17)
- Reviewing the requirement of the Stewardship Code in the light of best practice and other stewardship codes. (Q 24, Q25, Q28, Q29)
- Addressing the gap among investors: The FRC has already devised the three-tier system. However, the fact remains that half of those who were classified as tier 3 voluntarily removed themselves from the list of signatories. There are others who have not or may not wish to sign up to the Stewardship Code. We have heard views on both sides. Some argue that responsible investor stewardship will help contribute to a robust market; others argue that an overly rigorous stewardship requirement would scare investors away. ACCA supports that the former view, as we agree that high quality corporate governance will encourage trust in companies and build a robust economy in the long run.
- Reviewing the practice around independent assurance and methodology development: The existing assurance framework of the Stewardship Code which is restricted to Principle 7 is partially historical: Principle 7 was seen as the sole element of the Stewardship Code that can be made subject to the rigour of independent assurance engagements in a manner similar to independent assurance

engagements on internal controls. Since 2006 when the equivalent guidance on internal controls was developed, assurance engagements have evolved and there are different approaches. Therefore the usefulness of the independent assurance needs to be evaluated in light of the possibility to cover a wider range of information within the Stewardship Code if called for. (Q26)