Policy Liaison Group
Environmental, Social, and Governance

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Corporate governance

With Richard Moriarty, CEO of the Financial Reporting Council and Peter Swabey, Policy and Research Director at the Chartered Governance Institute

Richard Moriarty

Peter Swabey

The recently revised UK Corporate Governance Code dominated the PLG's inaugural roundtable discussion. The process suffered from a "difficult genesis" following several high-profile corporate collapses — Carillion, BHS, and Thomas Cook. The Financial Reporting Council (FRC) needed to balance strengthening the code with the Government's priority of supporting enterprise. Other key topics of discussion were guidance (or lack of) for internal controls, the Stewardship Code, regulatory powers over non-financial board members, and the UK's 'comply or explain' regulatory model.

Key takeaways

Governance is good

- Every company has controls in place to manage risks, which qualifies as governance, "the fundamental benefit is trust". Good governance leads to better decision-making, giving businesses licence to operate in society.
- Governance underpins everything an organisation does, including activity on the 'E' and 'S' in ESG.
- We need to address the perception that "governance is what big companies do" and recognise the UK does governance well.

- The UK's comply or explain approach, gives companies flexibility, allowing "principles to evolve" at a more manageable pace. By contrast, the US model of "comply or go to jail" has the opposite effect, rules have to be continually updated. Ultimately, better application of corporate governance leads to "better decision-making and a better world" (see more on comply or explain under 'Issues Raised').
- The UK's reporting environment is measured by content not volume — "weighing your annual report in kilos is not the way to demonstrate quality".

Revision of the corporate governance code

- Background: In October, the Government scrapped draft additional reporting requirements for large listed companies, underlining its ambition to lower corporate governance-related burdens on businesses. Long-awaited governance reform, symbolised by the establishment of a new regulator to replace the FRC, ARGA, did not feature in the King's Speech the following month.
- Many of the proposals submitted for the revised Corporate Governance Code, published in January, were rejected because they did not meet "the bar for high value". Internal controls emerged as the key priority.
- Notably, the FRC has not published guidance to help companies define their material controls. A deliberate move to ensure company boards "take charge, and take control of their material risks" (see internal controls under Issues Raised).

Stewardship code review — "taking a step back".

- The FRC is looking to build on stewardship issues raised in the Corporate Governance Code consultation — "there's an appetite out there for a conversation about how boards and investors and advisors relate to each other".
- The review is divided into three phases:
    - Discussions with issuers, asset managers, asset owners and service providers. Feedback will support phase 2.
    - Public consultation, set for summer 2024.
    - The revised Code will be most likely published in early 2025.
- The FRC wanted to find out whether the Code is creating the right type of interactions among asset owners and managers enabling good stewardship, or whether it is drifting towards a box-ticking process.

"Exploding" the notion that compliance is always better than explaining

- Unfortunately, the path of least resistance is to find a way of complying rather than explaining. Furthermore, companies should be encouraged to deliver robust explanations that explore the mitigations and risks that come from deviating from the Corporate Governance Code.

- Explaining involves engagement with shareholders, and shareholders in turn have to respond — the key question is how to reinvigorate that kind of dialogue.
- "Shoehorning into compliance, when it's clearly not good for the business, can't be good governance". Companies need to be given the confidence to explain.

Issues raised

Corporate Governance Code revisited — the "trade-off" in not providing guidance on internal controls

Concerns around not having detailed guidance for material controls:

- Disparate applications of the Code, particularly among smaller companies.
- The danger of companies "leapfrogging one another" towards higher standards, contradicting the original objective of making the Code less burdensome. "The guidance isn't there to tell me I've gone far enough".

The FRC's view

- Detailed guidance makes it "too easy for boards to not think for themselves" by outsourcing to consultants.
- The regulator recognises there's a tradeoff, and is content, for the time being, to cause a bit of uncertainty and have "people doing their own thing" in exchange for board primacy. Guidance may be issued at a later date.
- Some guidance has been released in response to queries from businesses around the number of controls — i.e. the number of principal risks will "drive the thinking" around controls. Even the largest businesses will have to limit the number of risks/ controls, ensuring they pass the "basic human test" of what board members will be able to cope with — "less is more".
- Admittedly, some board members will not know what internal controls are, but the more the regulator does, the more "there can only be one way of doing it". This is where consultancies have a role in supporting the interpretation for board members. Best practices and consensus between companies and their advisors will emerge over time.

Having non-financial directors under FRC's/ARGA's purview

- "It's a bit of an anachronism" that the FRC's powers currently only apply to board directors who are accounting professionals.
- It is very difficult to conduct effective due diligence on another company when

information is only available on accounting professionals sitting on the board. Is the net being widened?

- Under the existing plan for corporate governance reform, which should lead to the establishment of a bigger regulator, ARGA, to replace the FRC, powers will be extended to encompass non-accounting directors. When the legislation reaches Parliament, MPs will need to decide whether the remit should be limited to financial reporting. Not restricting the remit risks encroaching on other authorities. Certainly, non-accounting directors responsible for poor financial reporting should be held to account.

We would like to thank the members of our Advisory Board for their contributions and continuing support.

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secretariat@plgesg.org.uk