FRC consultation on the UK Corporate Governance Code

Summary of the proposed changes including the impact on directors' responsibilities for internal controls and other areas of governance

May 2023

On 24 May, 2023, the Financial Reporting Council (FRC) issued a consultation on proposed changes to the UK Corporate Governance Code (the Code). The changes touch on all sections of the Code, but the most significant are those around the responsibilities of directors for internal controls, which is in response to the recommendations in the Government's 2022 Response Statement (the Statement).

The Statement contained a number of other recommendations for companies, auditors and the regulator that are outlined in the Appendix. In this briefing note, we have focused on what you need to know now about the changes being proposed in the Code, in particular those relating to strengthening internal controls responsibilities, and how they differ to what is in the Code today.

Headlines

Code Section 4 – Audit, Risk and Internal Control

- Directors to make a "Declaration of whether the board can reasonably conclude that the company's risk management and internal control systems have been effective throughout the reporting period and up to the date of the annual report".
- The basis for the declaration must be described, including how the board has monitored and reviewed effectiveness.
- Scope of the declaration covers material controls over reporting (financial and non-financial reporting), compliance and operational controls.
- Material weaknesses or failures in controls must be disclosed.
- Guidance to be issued in due course—the consultation suggests this will provide significant detail about the possible structures, responsibilities and actions needed to support the declaration and what could be included in the basis for the declaration.
- Enhanced audit committee responsibilities around the integrity of environmental, social and governance reporting and for obtaining assurance thereon.
- Incorporation into the Code on a comply or explain basis of the Audit and Assurance Policy, the Resilience Statement and the new minimum standard on the external audit for audit committees.

Other sections of the Code

- Limited changes.

Timing

- Responses to the consultation due by 13 September 2023.
- Proposed effective date of accounting years commencing on or after 1 January 2025.

Impetus for change

These changes seek to further strengthen the UK's world renowned reputation for corporate governance. When they are finalised, we encourage companies to embrace both the form and spirit of the requirements as an opportunity to maintain and strengthen the UK's reputation as a trusted and leading place to do business. We believe that greater rigour in relation to internal controls also provides the opportunity to realise operational improvements and helps build a controls focused culture that promotes behaviours and activities to sustain change.

Please see our Restoring Trust Series which provides in depth practical advice about all of the key reform proposals.

If you have any questions, please speak to your usual PwC contact or:

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Who does this impact?

Currently, companies with a premium listing on the UK stock exchange are required to apply the Code on a comply or explain basis, regardless of their size, so these companies will be the main population impacted by the changes to the Code.

There are also some entities that voluntarily adopt the Code. The changes could also apply in a less direct way to large private companies that currently meet the thresholds in the Companies Miscellaneous Reporting Regulations and therefore have to make a Corporate Governance Statement. In making this statement, companies have to describe the “code” they have “had regard to”. Some choose the Code and so they will also have to “have regard to” the strengthening of internal controls provisions in the Code.

What is the proposed timeline?

The consultation proposes that the changes are effective for accounting years commencing on or after 1 January 2025.

Importantly, although the proposed changes to internal controls responsibilities require a declaration on the effectiveness of internal controls to be made in the annual report, it is proposed that the declaration covers effectiveness “throughout the reporting period..”. This implies that companies would need to be ready to comply from the start of their reporting period for which the changes become effective. For example, for 31 December year ends, this would be from 1 January 2025.

What are the most significant proposed changes?

Risk management and internal control

- Provision 29 (now provision 30) in Section 4 has been updated significantly to require that the board makes a more explicit “Declaration of whether the board can reasonably conclude that the company’s risk management and internal control systems have been effective throughout the reporting period and up to the date of the annual report”. This declaration will:
  - cover internal controls over reporting (financial and non-financial), compliance and operations
  - cover operating effectiveness throughout the reporting period, up until the annual report is issued
  - explain the basis for the board’s assessment
  - include a description of any material weaknesses and failures and how remedial action is being taken
- This goes beyond the existing Provision 29 in that it requires the directors to positively state whether controls have been effective or not, whereas the existing provision only requires that they undertake an annual review of effectiveness and report on that review in the annual report. The existing provision also does not require the basis to be explained.
- While the existing provision doesn’t say with any specificity the period that the current annual assessment would cover, it appears to be more of a point in time assessment of effectiveness. The proposed change appears to require an assessment on an ongoing basis rather than a one-off exercise.
- The proposed scope of the board’s declaration also goes beyond the existing Provision 29 by including non-financial reporting controls in the scope of the assessment. This is to reflect the growing stakeholder demand for and reliance on non-financial reported information.
- The focus of the declaration is on “material controls”, which is likely to mean those in place to guard against material risks to the company.
- Guidance is expected to be issued by the FRC that will cover a number of structures, actions and responsibilities needed to support the declaration. Although it is not expected to be prescriptive, it appears that it will be quite detailed, covering a number of important considerations when making the declaration, including: issues and areas that the board will need to consider in establishing and maintaining the risk management and internal control framework; duties and responsibilities of management and internal audit; the role of the external audit or other external advisors or providers of independent assurance; examples of circumstances when external advice/opinion/assurance may be beneficial or necessary; the difference between continuous monitoring and a review; the frequency of reviews.
- The guidance is also expected to address how to report against the Code’s amended requirements, including: explaining the basis for the declaration; a description of the processes undertaken; the role and work of the board and others; the framework or standard used; explaining material weaknesses identified and actions taken to remediate them.

Audit and Assurance Policy (AAP) and Resilience Statement

- Although the requirement for an AAP and Resilience Statement will be introduced through legislation and be required only for companies that have over 750 employees and £750m annual turnover, there are overlaps in the AAP and Resilience Statement requirements with the audit committee’s existing responsibilities in the Code. Therefore, the FRC is proposing to incorporate the AAP and the Resilience Statement into the Code on a comply or explain basis, thereby expanding their reach to all premium listed companies, rather than just those that meet the threshold described above.

Audit Committees and the External Audit: A Minimum Standard (for FTSE 350 companies)

- In a similar way to the AAP and Resilience Statement, the FRC is also proposing to incorporate the new minimum standard for audit committees into the Code on a comply or explain basis, thereby expanding the reach of this standard to all premium listed companies rather than just those in the FTSE 350.

Other proposed changes to the Code

There are limited proposed changes to other sections in the Code. The ones we would highlight are:

Section 1 – Board Leadership and Company Purpose

- A new Principle to focus reporting on activities and outcomes so as to demonstrate the impact of governance practices.
- Some amendments to bring more focus to board responsibilities for environmental and social matters.

Section 2 – Division of responsibilities

- Proposals to recognise the increasing demands on directors' time and how directors' other commitments are managed.

Section 3 – Composition, succession and evaluation

- Diversity and inclusion – Revisions to include a reference to inclusion, giving equal weight to all protected and non-protected characteristics, to encourage companies to consider diversity beyond gender and ethnicity and to improve transparency.
- Board performance reviews **–** Clarifications and guidance, mainly to reflect an earlier Chartered Governance Institute consultation and report.

Section 5 – Remuneration

- Changes to strengthen links to overall corporate performance - A strengthening of links between companies' remuneration policies and corporate performance in the wider sense, including ESG objectives, including an emphasis on the importance of transparency and a link to long-term sustainable success.
- Malus and clawback – Additional information proposed to be in remuneration reports around malus and clawback arrangements.
- Changes to improve the quality of reporting **–** Amendments to the factors considered in setting remuneration and the disclosures associated with these to reduce the tendency to boilerplate and clarify the reporting requirements.

Help and resources

If you have any questions on this summary or the broader reform agenda, please speak to your usual PwC contact or you can contact the individuals listed on the first page.

As noted above, you can also find out more about what a number of the key reforms might mean for you and what we hope is helpful, practical guidance for preparers seeking to proactively implement the proposals, including the strengthening of Internal Controls responsibilities, in our Restoring Trust Series found here.

Appendix – The key reforms and anticipated methods of implementation

There are a number of reforms that DBT is recommending are implemented. The anticipated method of implementation for all of the key proposals is outlined below.

Primary Legislation – the Audit Reform Bill

- Establishing a new statutory regulator, the Audit, Reporting and Governance Authority (ARGA), that will protect and promote the interests of investors, other users of corporate reporting and the wider public interest.
- Providing new measures to open up the market, including a new approach of managed shared audit in which challenger firms undertake a share of the work on large-scale audits. This will improve the quality and usefulness of audit and boost resilience, competition, and choice in the audit market.
- Bringing the largest private companies in scope of regulation in the definition of 'public interest entities', recognising the public interest in companies of this size.
- Giving the new regulator effective powers to enforce directors' financial reporting duties, to supervise corporate reporting, and to oversee and regulate the accountancy and actuarial professions.
- Reforming the regulation of Insolvency Practitioners to give greater confidence to creditors and strengthening corporate governance of firms in or approaching insolvency so that 'asset stripping' can be more effectively tackled.

Secondary Legislation – the Statutory Instrument

- Audit and Assurance Policy
- Material Fraud Statement
- Resilience Statement
- Distributable Reserves Statement and disclosures

UK Corporate Governance Code (the subject of this paper)

- Strengthened internal controls over financial reporting

Standards issued by ARGA

- Audit Committees and the External Audit: Minimum Standard