Provision 29 – Insights into high-quality disclosures

Introduction

In this document we outline our perspective on how the board can report on the effectiveness of material controls in a comprehensive and transparent manner. We indicate what could helpfully be included in each of the aspects of the Provision 29 disclosure and where it might be located.

Our focus is only on reporting under Provision 29 of the FRC Corporate Governance Code (the Code), so we do not address the other reporting requirements of the Code except to the extent that they may be relevant to Provision 29.

Refer to our website for other useful perspectives on approaching Provision 29 and what we are seeing in the market.

Provision 29 – A reminder of the requirements

The board should monitor the company's risk management and internal control framework and, at least annually, carry out a review of its effectiveness.
The monitoring and review should cover all material controls, including financial, operational, reporting and compliance controls. The board should provide in the annual report:

- A description of how the board has monitored and reviewed the effectiveness of the framework.
- A declaration of effectiveness of the material controls as at the balance sheet date.
- A description of any material controls which have not operated effectively as at the balance sheet date, the action taken, or proposed, to improve them and any action taken to address previously reported issues.

Below we outline how each of these disclosure requirements could be met:

> "The declaration is only one element of the reporting, and so the report should also include commentary on the monitoring and review process, as well as an explanation of how the board reached its decision. In most cases, we expect the report to be no longer than two pages. It is essential that the reporting remains proportionate and concise.
>
> **FRC, Provision 29 Mythbuster**

A description of how the board has monitored and reviewed the effectiveness of the framework

> Monitoring and review of risk management and internal controls are intended to allow the board to conclude whether the framework is properly aligned with strategic objectives; and satisfy itself that the framework addresses the company's risks and is being developed, applied and maintained appropriately. Monitoring and review aims to identify and evaluate areas for improvement in the design, implementation and operation of the framework.
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> **FRC Corporate Governance Code Guidance (the Guidance)**

01

The board's description of how it has monitored and reviewed the effectiveness of the framework could start with outlining the main elements, including: the governance structures in place and the role of the board; its committees and executive management; and the use of any externally recognised frameworks.

02

The board could then address how the framework is aligned with its strategic objectives and risks, and explain how the board is comfortable that it is applied and maintained appropriately.

03

The disclosure could then describe how the board has defined the scope of their material controls within the framework, including:

- A description of the methods for identifying, and potentially disaggregating, principal risks, including the materiality criteria used, and how the material controls in response to those risks have then been determined.
- A description of the possible impact on the company, its shareholders, and other stakeholders, should there be a deficiency in the material controls.
- A description of where qualitative or judgmental aspects of materiality have been considered alongside numerical criteria.
- Information about the types of control identified as material. For example, if they are 'entity-level controls' such as management or board reviews, frameworks, or more transactional-type controls, or a combination of both.

04

The FRC does not expect companies to provide a comprehensive list of all material controls. However, boards may wish to describe certain material controls, for example when discussing principal risks and uncertainties, and the related mitigating activities.

Although these mitigating activities are typically described at an aggregated level, it may be helpful to clarify if material controls form part of those activities and, where appropriate, provide examples of the types of material controls in place.

05

Key factors in the board's determination of the effectiveness of the material controls could then be outlined, for example:

- The utilisation of various lines of defence, whether internal or external; including self-certification, frequency of testing and reporting, specific areas of focus, and type of evidence received.
- The relevance of their effectiveness review 'as at the balance sheet date', including any procedures to keep the assessment current as at the year end, along with any subsequent work performed to maintain the declaration's accuracy when year-end material control activities impacting the declaration occur after the balance sheet date.
- How design and implementation effectiveness has been considered, in addition to determining operating effectiveness.

A declaration of effectiveness of the material controls as at the balance sheet date

06

The declaration is the outcome of the board's monitoring and review of the framework, therefore each board will have to determine its own specific declaration wording. A basic example could include: 'Based on the work carried out and evidence obtained as part of our review of the risk management and internal control framework [described above], the board has reasonably concluded that the material controls operating within that framework were effective at [balance sheet date].'

Note that Provision 29 appears to anticipate the board making a positive confirmation. A negative confirmation (for example, that the board has not seen anything that would cause it to think that the material controls were not effective) may not strictly comply with the Provision.

A description of any material controls which have not operated effectively as at the balance sheet date, the action taken, or proposed, to improve them and any action taken to address previously reported issues.

07

The declaration should describe any unremediated material control deficiencies as at the balance sheet date, along with the actions taken or proposed to enhance the effectiveness of these controls. It is anticipated that this will vary in level of detail disclosed, with some boards choosing to name the actual material control that has failed, and others describing the higher level risk area that the control is supposed to mitigate or the element of the internal control framework in which it sits. In terms of a description of the actions taken to address the failure, the Guidance acknowledges that in some cases there may be some sensitivity and the board "is not expected to provide any disclosures which in its professional judgment contain confidential information or any other information that could inadvertently affect the company's interests if publicly reported".

While not mandatory, it may be beneficial and of interest to stakeholders to disclose instances where a material control has been ineffective during the year, but has been remediated by the end of the year. For example, if it relates to a risk event, that actually materialised and has also been reported on.

08

An overview of the board's actions regarding any previously reported issues should also be included. This would allow boards to reassure stakeholders about their continuing focus on these issues.

General points

09

Comply-or-explain: The FRC has been clear that explain rather than comply can often be appropriate if an alternative governance arrangement better fits the facts and circumstances of the company or there is a short term challenge to compliance, e.g. a last minute board member resignation. We expect partial or full non-compliance with Provision 29 in particular, to be rare and most likely limited to situations where the board has been unable to determine the effectiveness of a material control(s) because there has been a transaction or operational change late in the year (e.g. a significant acquisition that has not yet been integrated). Either way, the board would be required to suitably and robustly explain any non-compliance with Provision 29 in its Code compliance statement. In the FRC's view, a good explanation should be clear and useful for stakeholders by describing:

- The justification for the chosen approach and any alternative governance arrangements.
- The duration and nature of the departure (e.g. temporary vs. long-term).
- How the approach demonstrates continued alignment with the principles of the Code
- Where further information can be found in the annual report.

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Location of Provision 29 disclosures: There are no specific requirements for where the Provision 29 disclosures should be presented within the annual report. Boards are therefore likely to incorporate them into the existing report structure rather than make significant changes. The following points may be considered:

- Under the Code, the audit committee is expected to take the lead in reviewing the risk management and internal control framework. As a result, much of the governance-related disclosure is likely to sit within the Audit Committee Report, with the material controls declaration potentially included alongside it. In this case, it should be made clear that the declaration is made on behalf of the full board.
- Many companies already describe their risk management and internal control framework within the principal risks and uncertainties disclosures. Given the expected link between principal risks and material controls, some may choose to include the Provision 29 disclosures in the same section.
- Alternatively, as the declaration on the effectiveness of material controls is the responsibility of the board as a whole, even if the related disclosures sit elsewhere, the declaration itself could potentially be included within the directors' responsibilities statement, as is often the case with the fair, balanced and understandable confirmation.

However it is determined to present these disclosures, boards should consider how relevant information is cross-referred to and contextualised throughout the annual report to ensure the disclosures are easy to follow.

For reference, see the **Appendix** for a summary of the areas within the annual report that commonly include disclosures related to the Code requirements on risk management and internal controls.

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Specificity: Boards to try avoid using generic language that lacks depth, instead offering detailed and specific information pertinent to the company's unique situation. The nature of reviews and material controls should be tailored to each company, considering the principal risks that could jeopardise the company's business model, future performance, solvency, liquidity, or reputation.

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Appendix

Provision 29 - Related coprorate governance disclosures

There is not yet a consensus on the best location for the Provision 29 disclosures, and one of the considerations for companies is how the disclosure fits in with the other relevant information disclosed in the annual report. This table summarises related corporate governance disclosures to provide a wider context for Provision 29, and highlights the relationships which exist across them. Not all disclosures are required to be made in the noted location – these are generally the locations where the information is disclosed in practice. This is also not a complete list of corporate governance disclosures required by the FRC Code or other regulations.

Strategic Report		
Disclosure	**Description**	**Source**
Risk management and internal control framework	In order to describe how it has applied Principle O of the Code, before describing the principal risks and uncertainties the board will often describe the risk management and internal control framework. Most descriptions will address key aspects of the framework, including risk appetite, changes in risk assessment and the governance structure (e.g. the roles of the board, its committees, and executive management).	FRC Code Principle O
Principal risks and uncertainties	Both the Companies Act 2006 (CA06) and the Code require disclsoure of the principal risks and uncertainties. The Code also requires a description of the mitigating activities undertaken in response to these. Note that the disclosure of mitigating activities is not a requirement to disclose material controls, but it is likely that the material controls sit within these activities. The CA06 disclosure is a Strategic Report requirement, so this information will almost always sit there.	CA06 / FRC Code Provision 28
Robust assessment of principal and emerging risks	The board is required to make a confirmation that it has undertaken a robust assessment of principal and emerging risks. This statement usually sits alongside the principal risks and uncertainties, though can also be made in the directors' report.	FRC Code Provision 28

Corporate Governance Report		
Disclosure	**Description**	**Source**
Code compliance statement	This compliance statement should confirm that the board has applied the principles of the Code, and that it has complied with the provisions, or explain non-compliance.	UKLR 6.6.6R(5) and (6), DTR 7.2
Audit committee report	The Audit Committee is required to report on its activities, including how it has reviewed the risk management and internal control framework.	FRC Code Provisions 25 and 26 (incl. Minimum Standard)

Directors' Report		
Disclosure	**Description**	**Source**
Corporate governance statement	The board is required to make a formal 'corporate governance statement' in the Directors' Report. The DTR has various disclosure requirements, including whether a corporate governance code has been applied (DTR 7.2.2) and describing the main features of the internal control and risk management systems in relation to the financial reporting process (DTR 7.2.5). Often, the Directors' Report will incorporate the separately-presented corporate governance statement by cross-reference so as to address the DTR requirement. Therefore the components of the corporate governance statement may sit outside the Directors' Report.	DTR 7.2

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