Year end reporting

Key reminders and prompts for Audit Committees

March 2024

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Foreword

This brochure aims to act as an aide-mémoire for Audit Committees during this March year end reporting season. The role and responsibilities of the Audit Committee are ever expanding in an increasingly challenging environment. This document has been designed to provoke your thoughts around key areas on the Audit Committee agenda as you go through your year end reporting.

The content has been updated where relevant since our December 2023 year end aide-mémoire. Although there are numerous areas addressed in this aide-mémoire, some of the points will be of greater relevance to your organisations and others may already have received a degree of focus.

I hope you find this document useful.

Ian Chambers
Chair, Audit Committee Network

Contents

Financial resilience and going concern

What's new

Challenges faced by businesses in 2023 are continuing into 2024. Inflation and therefore interest rate pressure is expected to ease but will still be higher than recent historical averages. This will continue to apply pressure on free cash flow and covenants. Leveraged debt markets also remain subdued, as do UK equity markets making it more difficult to raise financing or refinance if needed.

2024 will also bring a US presidential election and UK general election. This will bring political uncertainty to businesses and financial markets in H2 24, notwithstanding any other unexpected shocks that may occur.

Businesses therefore need to remain focused on managing their financial risk and resilience with going concern remaining a critical judgement for many Boards and Audit Committees throughout 2024.

This will include ensuring that management's forecasts adequately address keys risks in their assessment of going concern and that governance and controls around financial resilience are sufficiently robust.

This will enable businesses to be prepared for the key risks that may affect them and have a plan for how they can be mitigated to avoid liquidity or covenant issues.

Audit Committees should also continue to consider and challenge what actions management should be taking today to ensure the financial resilience of the business and to ensure that they are prepared ahead for any future uncertainties.

Key reminders and governance considerations

Audit Committees should actively monitor the following to identify any risks to financial resilience and ensure any identified risks are being adequately addressed and disclosed in the financial statements:

- Existing known risks to the business and how they are being mitigated.
- Forecast liquidity and covenant compliance headroom over the next 18 months under a 'severe but plausible' scenario.
- Robust treasury management and counterparty assessment.
- Resilience of the supply chain and risk and impact of disruption.
- Sensitivity and risks of a higher inflationary environment – especially raw materials and labour costs.
- Sensitivity to increased costs of borrowing and impact on available cash.
- Whether there are upcoming debt maturities (12 – 18 months) and risks to a refinancing when debt markets are tighter now than historically.
- Position of key external stakeholders such as lenders, credit insurers, bonding providers, regulators, pension trustees – risks / impact of their withdrawal of support.
- Position of key contracts which may expose the business to significant downside risk or liabilities.
- Material write offs and asset impairments.

What actions should corporates take / consider

With businesses facing continuing uncertainty, a focus on financial resilience is key. To strengthen the financial resilience governance framework, Audit Committees should encourage management to ensure robust controls and processes exist around:

- Financial forecasting and business planning especially liquidity and covenants forecasting.
- 13 week short term cash flow forecasting.
- Scenario planning.
- Robust tracking of actual vs forecast performance.
- Mitigation plans for downside scenarios.
- Treasury and liquidity management.
- Supply chain resilience assessment.
- Working capital management.
- Cost control and spend management.
- Workforce management.
- Key stakeholder management – e.g. lenders, pension trustees, key suppliers / customers.

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Accounting

What's new

Changes to accounting standards effective 1 January 2023:

New standards:

IFRS 17 Insurance Contracts - Insurance topic page.

A number of narrow-scope amendments:

- Amendments to IFRS 17 Insurance contracts: Initial Application of IFRS 17 and IFRS 9 – Comparative Information - Amendment to IFRS 17 - Initial application of IFRS 17 and IFRS 9 Comparative information.
- Amendments to IAS 1, Practice statement 2 and IAS 8 - Amendments to IAS 1 and IFRS Practice Statement 2 - Disclosure of Accounting Policies and Amendments to IAS 8 - Definition of Accounting Estimates.
- Amendments to IAS 12 Deferred tax: deferred tax related to assets and liabilities arising from a single transaction - UK In brief INT2021-10.
- Amendment to IAS 12 - International tax reform - pillar two model rules - UK In depth INT2023-10

Sustainability disclosure standards effective 1 January 2024:

- IFRS S1, 'General requirements for disclosure of sustainability-related financial information - UK In-brief INT2023-15 and UK In depth INT2023-05
- IFRS S2, 'Climate-related disclosures' - UK In-brief INT2023-15 and UK In depth INT2023-05

A number of narrow-scope amendments effective 1 January 2024:

- Amendments to IFRS 16 Leases: Lease Liability in a Sale and Leaseback - UK In brief INT2022-12.
- Amendment to IAS 1 - Non current liabilities with covenants.
- Amendment to IAS 7 and IFRS 7 - Supplier finance - UK In brief INT2023 03

What's new continued

A narrow-scope amendment effective 1 January 2025:

- Amendments to IAS 21 - Lack of Exchangeability - UK In brief INT2023-19

Take a look at our guidance on:

- Hyperinflationary economies at 31 December 2023.
- Accounting implications of the autumn statement 2023.
- Pillar Two Country tracker.
- Navigating IFRS Accounting Standards in periods of rising inflation.

Key reminders and governance considerations

FRC's annual review of corporate reporting 2022 / 2023: Report.

Recent FRC thematic reviews:

- Reporting by the UK's largest private companies
- IFRS 17 'Insurance Contracts' Interim Disclosures in the First Year of Application.
- IFRS 13 'Fair value measurement.

Take a look at our guidance on:

- Long-term contract accounting – common mistakes.
- Impairment of non-financial assets - common mistakes.
- FRC areas of focus: IAS 7 & cash flow classification.

What actions should corporates take / consider

Consider the following from the FRC's annual review of corporate reporting 2022 / 2023:

- The effects of inflation and other uncertainties.
- FRC's key disclosure expectations around top ten key reporting issues: Impairment of assets, Judgements and estimates, Cash flow statements, Strategic report and other Companies Act 2006 matters, Financial instruments, Income taxes, Revenue, Provisions and contingencies, Presentation of financial statements and related disclosures, Fair value measurement.
- Developments in corporate reporting.

Additional guidance

- **Further information is available in our recent publication; March 2024 year end accounting reminders - IFRS**

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Corporate reporting and governance

What's new

SEC adopts climate-related disclosure rules

- In March 2024 the SEC finally adopted rules on the disclosure of the risks and impacts of climate-related matters, including by Foreign Private Issuers. The new rules include disclosures relating to climate-related risks and risk management as well as the board and management's governance of such risks. In addition, the rules include requirements to disclose the financial effects of severe weather events and other natural conditions in the audited financial statements. Larger SEC registrants will also be required to disclose information about greenhouse gas emissions, which will be subject to a phased-in assurance requirement.
- The final rules differ in several respects from the initial proposal, most significantly in changes to the financial statement footnote disclosures as well as reductions to the scope of and number of registrants subject to the greenhouse gas emission disclosures. They leverage some concepts from other new regulations and standards, however they differ in many ways and there are no equivalency provisions in the new rules.
- The earliest effective dates start with reporting on 2025 information in 2026, with additional delays for smaller companies and greenhouse gas emissions disclosures. While there has already been some legal challenge to the new rules, given the timing and volume of information required Audit Committees should encourage their management to consider whether they fall in scope and start to prepare now.

Size thresholds for EU sustainability reporting (CSRD) raised

- The EU has adjusted the size thresholds for micro/small/medium and large undertakings, to take account of inflation. Large undertakings have reporting obligations under the EU's Corporate Sustainability Reporting Directive but the categorisation is also relevant for other purposes. The new thresholds for large undertakings are:
  - Balance sheet: Increases from €20 million to €25 million.
  - Turnover: Increases from €40 million to €50 million.
  - Employees (average number): Unchanged at 250.
- The classification of an undertaking as large is based on meeting two out of the three size thresholds above.
- The new thresholds will apply for financial years beginning on or after 1 January 2024. However, EU member states may allow undertakings to apply the new thresholds for the financial year beginning on or after 1 January 2023.

Useful links:

- (PwC) ESG regulations and your company > Actions you can take now to transform your ESG reporting strategy
- (SEC) Press release on climate-related disclosure rules
- (EU) Adjusting SME size criteria for inflation initiative
- Updated CSRD material Worldwide impact of CSRD, are you ready?

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Corporate reporting and governance (continued)

Key reminders and governance considerations

- There are relatively few new reporting requirements for the remainder of the 2023/24 reporting season, particularly as companies with March year ends and later implemented the FCA's disclosures on diversity and inclusion targets last year. The main new requirements are therefore as follows:

Climate-related financial disclosures - emerging themes

- As a reminder, climate reporting has been extended under the Companies Act beyond listed companies to AIM companies with more than 500 employees and private companies that exceed both £500m turnover and 500 employees for periods beginning on or after 6 April 2022. The reporting requirements are very closely aligned with the TCFD framework and need to be included in a non-financial and sustainability information statement within the strategic report. Both TCFD and the new Companies Act requirements apply for main market listed companies that exceed the relevant thresholds.
- With much of the December reporting season now complete our view is that progress has been mixed with an understandable emphasis on compliance as opposed to providing high quality, extensive disclosures in year one.

FRC Minimum standard for Audit Committees

- The FRC has published a Minimum standard for Audit Committees, focusing on the appointment and oversight of the external auditor. The standard largely pulls together existing provisions of the UK Corporate Governance Code and FRC guidance into a mandatory basis for future monitoring and enforcement by ARGA. Until ARGA is established the standard applies to FTSE 350 companies on a comply or explain basis with immediate effect.

What actions should corporates take / consider

- On the climate-related financial disclosures we think there are five key questions to ask:
  - Do we have an explicit "Non-financial and sustainability information statement" heading in our strategic report?
  - Have we made it clear how material we believe climate-related risks and opportunities are to our strategy and business model?
  - Have we included all the required disclosures, consistent with our assessment of materiality?
  - Is all material information provided in the Annual Report & Accounts (ARA)?
  - Are the disclosures clearly signposted in the statement or elsewhere in the ARA?
- Corporates should also continue to monitor and plan for ESG developments - particularly the implementation of the ISSB standards and (where applicable) the CSRD and SEC disclosures. See further detail on page 9.

Regulatory matters

What's new

FRC issues the revised UK Corporate Governance Code
In January, the FRC released the revised UK Corporate Governance Code (the Code) and accompanying guidance, following an extensive consultation with significant stakeholder feedback.

Below is a summary of the key changes to the Code in relation to boards' responsibilities for systems of risk management and internal control - there are no other substantial changes:

- ***Annual controls declaration required -*** boards will be required to make an annual declaration in the annual report on the effectiveness of all material controls as at the balance sheet date.
- ***Wide ranging scope covering all material controls -*** the declaration will cover all material controls, including (i) financial, (ii) operational, (iii) compliance controls and (iv) non-financial reporting controls.
- ***Basis of declaration to be disclosed -*** it will include a description of how the board has monitored and reviewed the effectiveness of its risk management and internal control framework.
- ***Need to consider 'material' control deficiencies*** - it will also include a description of any material controls that 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.
- ***Delay in effective date -*** the effective date of the revised Code is financial years beginning on or after 1 January 2025 - this will apply to all aspects of the Code with the exception of the declaration on material controls, which will be financial years beginning on or after 1 January 2026. Until these effective dates, companies should follow the existing 2018 Code.

We expect that most companies will have to do more work to support the new declaration. The additional year the FRC has allowed before the effective date of the new declaration will give companies more time to prepare and we would encourage you to start thinking about your current process for monitoring and reviewing systems of risk management and internal control this year and, for example, consider a dry run of the new declaration in 2025 to support readiness in 2026.

With this in mind we have updated our Restoring Trust Guide on risk management and internal control, which focuses on what we think would be a robust approach for boards to take in overseeing, monitoring and reviewing their systems of risk management and internal control. This is equally applicable under the existing and revised Code but would, in particular, help boards to develop a solid basis on which to make the new declaration.

To supplement this Restoring Trust Guide, we held a webcast and issued some FAQs here, covering the recent developments in corporate governance, in particular as they relate to the FRC's changes to the Code around risk management and internal controls.

FRC Issues revised Ethical Standard
The FRC has published a revised ethical standard for audit engagements and other public interest assurance engagements. These new rules will be effective for accounting periods starting on or after 15 December 2024.
Broadly, the revised Ethical Standard has relatively minimal impact in terms of changes but does do three main things:

1. It simplifies some of the drafting from the current Ethical Standard 2019 and provides additional clarity in a limited number of areas.
2. It takes into account recent revisions made to the international IESBA code of Ethics designed to ensure high standards of ethics and independence are applied consistently by UK audit firms and their networks.
3. It confirms that the FRC intends to remove the Other Entities of Public Interest (OEPI) category which was introduced in 2019, but only when the government implements their revised Public Interest Entity (PIE) definition. At this stage the detail and timing of the new PIE definition is uncertain and it is not currently anticipated to be finalised in legislation before 2026 so there is no immediate impact.

The FRC acknowledges that a number of private equity interests have raised concerns about the loss of the private equity carve out, should the OEPI definition be removed, but has deferred to the Department for Business and Trade (DBT) to make any future decisions on whether this will be included in any future PIE definition. Similarly, the FRC has not made any changes to the construct, or application of, the 70% non-audit services fee cap for PIE auditors, but they do acknowledge the volume of feedback received in this area, which they will also share with DBT.

Regulatory matters (continued)

What's new continued

UK Listing Regime Reform

The FCA issued a set of consultations on proposed changes to the UK Listing Rules during 2023. In December 2023 they published detailed proposals for Listing Rules reforms, CP23/31. The detailed proposals represent a generational change in the listing regime in London and are expected to come into effect later in 2024. The FCA has consciously chosen to reduce regulation, with an acknowledged transfer of risk to investors, and directors. There are 5 key areas of proposed changes:

1. Combining the existing Standard and Premium listed market segments into a single **Equity Shares in Commercial Companies ("ESCC")** segment.
2. For **Significant Transactions,** removing the requirement for a **shareholder circular and vote** with a modified Significant Transaction notification **disclosure regime.**
3. Relaxation of the eligibility requirements for **IPOs**.
4. Changes to the **Sponsor** regime.
5. Greater flexibility to allow dual class share structures (**DCSS**) with weighted voting rights.

Further detailed proposals for changes to the Prospectus Regime are to follow with consultation later in 2024.

Global geopolitical landscape

2024 will be a record year at the polls as, for the first time, over half the world's population may be casting votes in over 70 territories. Key overseas elections to watch are the EU Parliamentary elections, the US presidential election, and general elections in South Africa and India.

The rise of 'national conservatism' in countries ranging from the US to the Netherlands gives rise to the risk of countries decoupling from global institutions resulting in regulatory fragmentation as different markets begin to pass requirements in their own interest, not considering impacts globally.

The changing geopolitical landscape in 2024 looks set to only increase the challenges multinational companies are facing to keep abreast of these changing and diverging requirements. It also risks creating confusion and even a possible lack of trust for global stakeholders, such as investors, who do not appreciate jurisdictional differences.

New and upcoming consultations

The following consultations have been or are expected to be launched during 2024. We strongly encourage companies to engage in these consultations and provide feedback where relevant to them.

The Sustainability Assurance Market Study

The FRC has launched its first market study, which looks at challenges within the UK market for sustainability assurance services and is inviting all parties to submit comments and evidence by 13 June 2024.

The Stewardship Code

The FRC is undertaking a fundamental review of the UK Stewardship Code 2020. It is planning targeted outreach, focussed around the four main groups affected by the Stewardship Code's principles and application. This outreach will inform the second phase, which will be a public consultation, planned to launch after the 2024 AGM voting season.

Non- financial reporting review

The first phase of the Government's non-financial reporting review is complete and amendments to legislation are to be implemented this year which will increase monetary thresholds for company size categories by approximately 50%, remove certain duplicative reporting requirements from the Directors' Report and streamline detailed remuneration reporting requirements. Further changes are expected to be consulted on in coming months.

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Environmental, Social and Governance (ESG)

What's new

SEC adopts climate-related disclosure rules

As set out in the Corporate Reporting and Governance section earlier in this report, the SEC has adopted long awaited climate-related disclosure rules. The final rules reflect the Commission's efforts to respond to investors' demand for more consistent, comparable, and reliable information about the financial effects of climate-related risks on a registrant's operations and how it manages those risks while balancing concerns about mitigating the associated costs of the rules.

Organisations worldwide prepare for reporting under the EU Corporate Responsibility Reporting Directive ('CSRD')

To comply with the CSRD, organisations must identify their material sustainability impacts, risks and opportunities using a "Double Materiality" Assessment ('DMA') approach, which broadens the concept of materiality from a sole focus on financial materiality to one that includes a view of impact on stakeholders and society.

This two-pronged perspective adds a level of complexity to materiality assessments. Companies must assess if a sustainability matter (a topic, sub-topic or sub-sub-topic) is material from a financial or impact perspective or both. A sustainability matter needs to be material from only one of the two perspectives to require disclosure. To make these determinations, companies will likely need a greater understanding of sustainability matters in their value chain to measure and assess financial and impact materiality. These steps are likely new for many companies.

Many organisations are currently completing their Double Materiality Assessments, including UK companies with a footprint in the EU meeting the relevant size thresholds. We present some common themes on our website here which include a lack of boundary setting, over reliance on previous materiality assessments performed for a different purpose, placing unequal weight on either financial or impact materiality and running the assessment in a siloed manner.

Corporate Sustainability Due Diligence Directive

A revised text of the EU Corporate Sustainability Due Diligence Directive ('CSDDD' or 'CS3D') was endorsed by the European Council on 15th March 2024 and is expected to move forward to become formally adopted, subject to approval by the European Parliament and European Commission.

Both the CSRD and the CSDDD collectively aim to strengthen sustainability within the European corporate framework. While the CSRD focuses on expanding sustainability reporting, the CSDDD emphasises the need for companies to actively engage in responsible behaviour and aims to establish rules for companies to identify, prevent, mitigate and account for adverse environmental and human rights impacts in their operations and value chains.

Initially the CSDDD was designed to apply to EU companies with a minimum of 500 employees and a turnover of €150 million. However, the revised text increases the thresholds to a minimum of 1,000 employees and a net turnover of €450 million. As a consequence, a significant number of companies (reported to be almost 70%) are expected to no longer be caught by the proposed rules. The revised text has also dropped the previous approach of specifically targeting businesses with a higher risk of environmental or social harm.

What actions should corporates take / consider

Assurance of ESG disclosures

Companies need to work harder to gain stakeholder trust, and to make the right choices around future plans to turn commitments into actions, both of which depend on credible ESG data. As a result, an increasing number of organisations are seeking assurance over their reported ESG performance metrics.

Whilst assurance of ESG data is currently voluntary in the UK, the CSRD - and other ESG reporting regimes worldwide - come with a mandatory requirement for annual assurance.

Organisations should be thinking about:

- Appropriate systems, processes and controls to collate and report the ESG data.
- Existence and availability of complete, accurate and understandable methodology documents for all ESG data points, including specific definitions that are understood and consistently applied.
- Access to third party data.
- Availability of underlying evidence, the audit trail.
- Education of relevant stakeholders.
- Roles and responsibilities, across functions.
- Governance structure.

Audit Committees are expected to play an increasingly important role in the supervision of ESG assurance going forward.

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Internal audit

What's new

The need for assurance remains paramount. Economic and geopolitical uncertainty has maintained the world's permacrisis state and even though the direct disruption caused by the pandemic has largely disappeared, other risks posed by climate change, globalisation and the conflicts in Ukraine and now the Middle East have taken its place. Resilient and sustainable growth has become increasingly difficult to create with disrupted supply chains and technology becoming more and more important to operations, profitability and our daily lives. Many businesses have accelerated the pace of digitalisation since the pandemic to remain relevant and to improve efficiency and productivity but the energy crisis and recent interest rate increases have eroded the dividend from this change for many. Understanding what is driving changes in risk at a macro and micro level, in real time, is as critical for survival as transforming operating models to leverage technology (including AI). Our fragile economic situation, which has deteriorated in the last year, makes the case for change even stronger. In response, PwC's 27th global CEO survey found that over 40% of UK CEOs have implemented a form of AI in the last year, some 25% ahead of the global average.

So how do Internal Audit plans remain relevant with risks changing so quickly? How does the Internal Audit function evolve and base its assurance at the centre of issues in an environment with such a wide range of risks? How does Internal Audit ensure it is strategic and has the skills and resources it needs to cope with AI? Is there sufficient use of data and technology, centres of excellence, proactive assurance techniques, benchmarking and insight? Is Internal Audit able to challenge the business, does it have the right sponsorship? How does it play a value add role across increasingly developed lines of defence?

Key reminders and governance considerations

- Audit and Assurance Policy – is it clear as to what assurance is in place in relation to externally reported information? Is the assurance sufficient and of the right quality? How does Internal Audit assurance link to other second and first line governance control in a coordinated way?
- The IIA are consulting on a revised Internal Audit Code of Practice that once implemented will cover financial services, private and third sector organisations. This will ensure the UK Code aligns with the new Global Internal Audit Standards and reflects other changes including the revised UK Corporate Governance Code, along with evolving industry practices. IA functions should consider the changes in this guidance when developing plans.
- Assurance maps – valuable insight into the activities in place to assure the responses to key enterprise-wide business risks. Is your map up to date and is it considering for example:
  - increased foreign cyber threats
  - supply chain disruption
  - loss of customer confidence due to reputational risks
  - regulatory changes driven by climate
  - energy resilience
  - cost of finance changes
  - AI governance?
- TCFD – applicable to all listed companies from 2022. Consider training and skills needed by Internal Audit to appropriately support governance and oversight.

What actions should corporates take / consider

- Ensure alignment between the Internal Audit plan and your board level risks. The key topics we are seeing as uppermost on the board agenda include:

  – workforce planning
  – supply chain resilience
  – access to skills and resources
  – cyber risk, and ransomware threats in particular
  – ESG strategy and sustainable supply chains
  – TCFD reporting
  – AI.
- Agree the scope and nature of Internal Audit support in relation to the ongoing regulatory reforms – one key role may be to help build the Audit and Assurance Policy with integrated assurance to leverage different streams of assurance and manage cost.
- Consider whether Internal Audit should reassess its operating model in light of the volatile risk landscape. For example, to capture the benefits of remote / hybrid working, to use data and technology in new ways, and to ensure a balance of access to specialist skills alongside regional / global internal audit centres of excellence?
- Consider AI and how this will change, augment or even replace current resources deployed in the Internal Audit domain.

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Cyber

What's new

Ransomware

- Remains the most impactful cyber risk faced by organisations worldwide.
- Poses operational, financial and reputational risks - even a going concern risk in most extreme cases (e.g. KNP Logistics which collapsed after a cyber incident).

Supply chain vulnerabilities *(third and fourth parties)*

- Numerous cyber incidents caused by weaknesses in the technology that our clients rely on, including software used to facilitate secure remote working. These incidents have led to data breaches and operational disruption.
- Third parties in the supply chain continue to pose challenges for both cyber security and data protection.

Resilience

- Global recognition now that successful cyber attacks are both increasingly common, and increasingly destructive.
- Businesses need to be prepared to respond and recover from a destructive cyber attack - both in terms of recovering IT but also in the ability to function as a business in the total absence of IT for weeks.

Transparency

- Regulators and markets globally are demanding greater transparency over cyber security capability, governance and incidents (e.g. new SEC rule).

Key reminders and governance considerations

- **Frequency of cyber discussions and at what level of the organisation:** does the Board only have an ad hoc approach to reporting on cyber capability?
- **Transparency**: does the Board have sufficient visibility of cyber risk and incidents to meet reporting expectations (especially in light of new requirements such as the new SEC rule)?
- **Roadmap:** Is there a mandated cyber improvement programme and roadmap(s) with Board reportable progress? How often are these reviewed?
- **Budget:** how often is the budgetary commitment to security / cyber defence and positioning revisited? Is investment in maintaining IT infrastructure seen as a cost to be minimised or a strategic investment to ensure adequate cyber security? Is this sufficient for industry sector and / or sufficiently benchmarked against peers?
- **M&A:** how is cyber security managed during business transactions, such as the purchase or disposal of other companies?

What actions should corporates take / consider

- Has the "minimum viable business" been identified and documented?
- Has the "minimum viable infrastructure" to ensure business continuity been identified and have business continuity plans been regularly reviewed and exercised - including how technology would be recovered from a cyber attack, and how the business would function in the total absence of IT?
- Has the Board reviewed and approved the governance of cyber security, and the process for escalation and reporting of incidents in the light of growing regulatory expectations?
- Review third party contracts / deliverables to ensure cyber security risk / KPIs are specifically addressed to risk appetite and industry, legally enforceable and reviewed within the procurement process as a whole.
- Reflect on the key learnings for all organisations coming out of the attacks on the Irish Health Service and the British Library.

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Internal controls

What's new

As noted in the section on Regulatory matters, the FRC has issued a revised UK Corporate Governance Code which enhances boards' responsibilities around risk management and internal control.

What actions should corporates take / consider

When it comes to strengthening internal controls under the new declaration in the revised Code (and equally relevant under today's Code), most companies will not be starting from scratch but many will have additional work to do. Today, companies have variable approaches to the structure of their internal control framework and whilst there are established financial, operational and compliance controls in place, there is often a lack of structure and formality particularly around monitoring the effectiveness of the systems of internal controls. Preparation for stronger internal controls will take time but there are some practical steps companies can take now to determine where they are in the internal controls continuum:

1. Focus on control design before effectiveness. Our experience suggests that much of the benefit comes from ensuring that the key controls are designed effectively and that there is education on behaviours needed to monitor and assess controls with greater rigour and consistency. Assessing the maturity of controls design will be a key part of this**.**

For example (i) performing a controls maturity assessment of your current control environments to identify gaps (ii) conducting pilot reviews to validate control design and the effort needed to enhance (iii) establishing the governance and resource requirements needed to make necessary improvements to internal controls.

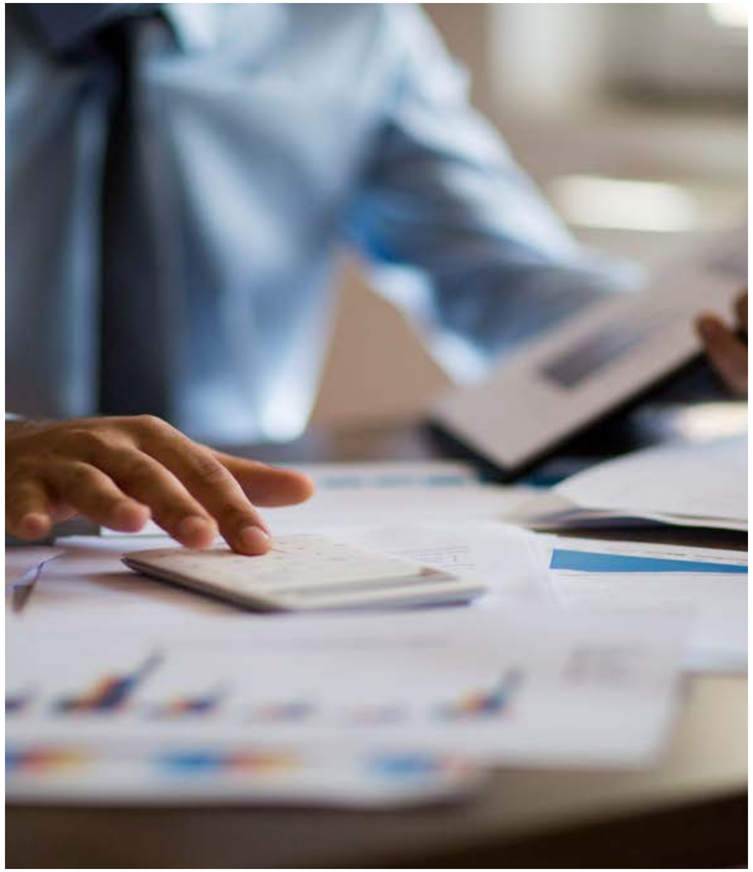
2. Define the 'in scope' reporting, operations and compliance controls. This should be based on materiality, areas of significant judgement / estimates, the principal financial, operational and compliance risks and related controls identified in the enterprise risk register. This should include material fraud risks and related key controls.

3. Produce a roadmap. Include key activities to enhance the control environment and develop a timetable working backwards from a potential statement date. Prioritise areas of significant change and complex business processes. Designing controls right the first time and rationalising control improves business efficiency and helps reduce cost over time.

4. Consider your IT environment. Ensure that your operational, financial and compliance functions are connected to the IT function. Consider how reliant they are on the IT environment and any challenges in that environment and how automation and analytics can be incorporated into control design to improve effectiveness.

5. Consider the level of assurance needed (internal and external). Evaluate the current process in place for the Board to maintain and annually review effectiveness of the system of internal control. Compare this to what is needed for a more formal statement and identify the options to achieve this.

When it comes to the Board's responsibilities for oversight, monitoring and review of the systems of risk management and internal control and supporting their new declaration, we have developed a practical guide that walks through what we think are the key elements of such a process. It and a number of FAQs can be found here,



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Fraud and investigations

What's new

The Economic Crime and Corporate Transparency Act amends the standard for corporate liability for economic crime and introduces a new 'Failure to Prevent Fraud' offence:

Corporate liability - the Act amends the 'identification doctrine' such that senior management can bind the corporate in acts of economic crime, a lower threshold than the previous requirement to show the individual was 'directing mind' of the corporate.

New Failure to Prevent Fraud offence - relevant body is guilty of an offence if "*a person who is associated with the body ("the **associate**") commits a fraud offence intending to **benefit** (whether direct or indirectly) - (a) the relevant body, or (b) any person to whom, or to whose subsidiary undertaking, the associate provides services on behalf of the body.*"

Defence*:* to have reasonable prevention procedures in place or demonstrate that it would be unreasonable to expect the body to have any prevention procedures in place. Subject to guidance (see opposite).

- An **'associate'** can include an employee, agent or subsidiary, or anyone else who performs services for / on behalf of the company.
- Offence requires fraud to **benefit** the organisation (i.e. not applicable should relevant body be the victim).
- New offence applies to corporates that meet two out of three criteria: turnover over £38m, over 250 employees or net assets of over £18m.

Key reminders and governance considerations

- Consistent with previous UK 'failure to prevent' legislation, **official guidance** (expected in next 3 months) will follow to develop what is considered reasonable fraud prevention procedures. In keeping with previous guidance on reasonable procedures (Corporate Criminal Offence guidance from HMRC) or adequate procedures (Bribery Act 2010 guidance from the Ministry of Justice), we anticipate an approach based on the following six key principles:
    - top level commitment
    - communication
    - risk assessment
    - proportionality of risk-based prevention procedures
    - due diligence
    - monitoring and review.
- An implementation period is also expected.
- Understanding the fraud risks facing an organisation is a critical success factor for an effective and cost-efficient fraud risk management programme. Without a robust fraud risk assessment, control activities are likely to be high-level and poorly targeted.
- A unique feature of fraud risk is that fraudsters set out to circumvent internal controls and / or exploit control weaknesses. Fraud risk should be assessed on the basis of the 'inherent' risk, with a separate assessment of any mitigating internal controls.

Fraud and investigations (continued)

What actions should corporates take / consider

The following questions will help Audit Committees to explore the fraud risk maturity of their organisations:

Prepare

- Do our policies and procedures reflect a holistic and up to date reflection of the fraud and financial crime landscape?
- Does our fraud risk assessment reflect an up-to-date view of all components of our organisation and the risks we face?
- How does our risk assessment consider internal and external fraud threats? Does it differentiate between fraud that benefits the organisation vs fraud where the organisation is the victim?
- Have we identified the key controls to mitigate fraud risk? How are these stress tested?
- What are management doing to prevent and proactively identify fraud?
- Is fraud risk sufficiently incorporated into our internal audit plan?

Respond

- Do we have an incident response plan (triage with key stakeholders) that ensures transparent and consistent response?
- Does the Audit Committee have sufficient visibility of whistleblower reports and matters under investigation?
- Who investigates fraud cases – do they have the right independence, expertise, resources and technologies?
- Do we have the right procedures in place to address regulatory disclosure and reporting obligations relating to fraud?

Emerge stronger

- Is our fraud reporting sufficient?
- What steps do we take to learn from incidents of fraud or other control failures?
- How are fraud prevention and detection techniques evolving and are we keeping up with the threats?
- How do we ensure the ongoing effectiveness of our counter fraud activities?

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Tax

What's new

OECD Pillar Two
Major tax reform agreed in October 2021 which aims to put a floor on international tax competition by introducing a global minimum tax rate of 15% for larger global MNEs.

- UK legislation is now enacted, including a domestic minimum tax for UK entities, which will also apply to UK groups.
- Further law changes to come and guidance is evolving. Keep up to date with our Pillar Two country tracker.
- Tax changes across the rest of the world (including the US and UAE) as a result of the Pillar Two changes.
- Amendments issued for IFRS and UK GAAP providing an exception to accounting for deferred tax on Pillar Two, but introducing more qualitative and quantitative disclosure requirements.

Tax transparency
- EU directive on Public Country by Country Reporting (CBCR) covering large companies with operations in the EU for periods starting after 22 June 2024.
- However, it is important to track local requirements, as some territories have early adopted and disclosures may be required earlier.

Increased tax authority disputes
- Focus on business models and transfer pricing, interest deductions and general uncertain tax positions (notification required in UK, Canada, US and Australia).

Key reminders and governance considerations

FRC's annual review of corporate reporting 2022 / 2023 continued to identify tax as one of the top ten issues in 6th position. Areas of focus remain on the key judgement areas and associated disclosures:

- deferred tax asset recognition
- uncertain tax positions
- consistency of tax disclosures.

The FRC announced one of the areas of supervisory focus for 2024 / 2025 as risks related to the current economic environment which includes the recoverability and recognition of tax assets/liabilities. There is further guidance in the thematic review on Deferred tax assets which was published in 2022.

ESG linkage with tax:

- Governments use tax to change behaviours, e.g. plastic tax, carbon taxes, etc.
- Tax policy alignment with TCFD disclosures (which are another area of focus for the FRC), business model and tax strategy.
- Investor transparency requirements on workforce, CBCR, etc.
- CSRD needs to align with tax areas such as transfer pricing.

What actions should corporates take / consider

- OECD Pillar Two is likely to involve a significant increase in compliance on tax and finance functions. Make sure that you have appropriate processes in place, as UK legislation is effective in 2024 and consideration will need to be given to the approach to calculating the current tax impact for both interim and year end reporting.
- Ensure controls and processes are in place to track all tax law changes including direct and indirect taxes.
- Maintain a global tax risk register with appropriate controls to identify and manage disputes (for both direct and indirect taxes).
- Consider the alignment of the tax strategy with the ESG strategy and what the public narrative would be on explaining your CBCR.

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Pensions

What's new

- Recent high inflation and discretionary increases
- Higher post-COVID mortality rates
- Increased surpluses leading to insurance transactions
- Key announcements from Autumn Statement 2023
- Virgin Media High Court Ruling

Key reminders and governance considerations

- Whilst there has been a downward trend in annual inflation, the recent high inflation has had implications for pension schemes, since the majority of UK pension benefits are increased in line with inflation. Schemes' exposure is commonly reduced by caps being applied to such increases (for example, increases to pensions in payment are often limited to 5% each year), but there may still have been large increases to obligations arising as a result.
- Furthermore, trustees of some pension schemes may seek to mitigate the cost of living impact for members by seeking to waive the annual cap, although they will usually need employer consent for this. Companies may be best advised to engage with their auditors where such discretionary pension increases are being considered or awarded during the year as this could potentially have P&L implications in certain circumstances and possibly lead to a constructive obligation.

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- Following the COVID-19 pandemic, mortality rates were high relative to pre-pandemic levels in the latter part of 2022 and the first half of 2023. This led to relatively pessimistic views on future longevity rates. However, mortality rates in the second half of 2023 and the first few months of 2024 have been closer to pre-pandemic expectations, dampening these views. Nevertheless, relative to last year, we are generally seeing a trend of lower life expectancies being assumed for accounting purposes, as the heavier observed mortality rates have been reflected in published mortality projection models.
- The prolonged period of high interest rates, leading to relatively high bond yields, means that many companies are seeing large surpluses on their balance sheet. This has led to a greater volume of schemes insuring members' benefits (ultimately moving the assets and liabilities off balance sheet). As the premium paid to the insurers is usually considerably higher than the accounting liabilities, there can be a significant balance sheet impact.
- For companies going down the insurance route, there is continued discussion on whether it is appropriate to recognise surpluses as an asset on their balance sheet. There has also been scrutiny from auditors over the correct tax rate to apply to the balance sheet asset (although the refund tax rate has changed - see the next page).
- For monitoring of your pensions accounting assumptions against market trends, see the PwC quarterly accounting trends page.
- PwC estimated that UK pension schemes collectively reached yet another record funding level in February 2024.

Pensions (continued)

Key announcements from 2023 Autumn Statement

- **A pot is for life.** The Chancellor announced that employees will be given the "legal right to require a new employer to pay pension contributions into their existing pension". This is an initiative designed to provide value for individual savers and to eradicate the problem of individuals building up multiple small pension accounts over their working life. It represents a radical change in approach from the current system where employers select a pensions provider on behalf of employees.
- **Foundations laid for a defined benefit 'run-on' model.** Following the announcement in the 2023 August Statement, in February 2024 the Department for Work and Pensions (DWP) launched a consultation on a regime that will allow DB schemes to 'run-on' and potentially repay surplus to the sponsor, including an option for these schemes to pay a higher Pension Protection Fund (PPF) levy in return for 100% PPF coverage.
- This appears to pave the way for a model where a DB scheme could run on rather than buyout with an insurer, distribute surplus above a threshold to the sponsor but offer a PPF-backed guarantee to members. Many sponsors and trustees of well-funded schemes may find this option attractive, particularly if the levy and other costs can be met from the scheme's assets.
- PwC estimates there are around 350 larger, well-funded schemes (with c.£900bn of assets) facing a challenging decision of whether to move to insurance or to run on.
- New analysis from PwC here shows if DWP moves forward with its consultation plans, it could potentially unlock £340bn for schemes to run-on and encourage investment in UK plc.
- Aligned with the policy intent of this consultation, the rate of tax applied to refunds of surplus from defined benefit pension schemes has been reduced from 35% to 25% with effect from 6 April 2024.
- A new **Growth Fund** will be established by the British Business Bank to help facilitate investment by UK pension funds into high-growth UK start-ups. The Chancellor also reconfirmed £250m in Government support to establish two further investment vehicles that can be used by pension funds to invest into UK science and technology companies.
- **Abolition of the Lifetime Allowance ("LTA")** - the government will legislate in the Autumn Finance Bill 2023 to remove the LTA, which will take effect from 6 April 2024.

Virgin Media ruling

- In June 2023, the High Court issued a ruling in the Virgin Media Limited v NTL Pension Trustees II Limited case relating to the validity of certain historical pension changes, potentially impacting defined benefit plans across the UK. Legal summaries from firms like Linklaters and Sackers offer background information on the case. The ruling suggests that certain changes to pension scheme rules may not have occurred, potentially increasing scheme liabilities beyond previous estimations. The extent of this impact depends on the nature of the invalidated amendments. However, the ruling is subject to appeal, with the appeal scheduled for June 2024.

What actions should corporates take / consider

Governance

- Consider what the February 2024 consultation on "run-on" might mean for your DB pension scheme in terms of considering whether to plan for insurance or not.

Accounting

- Understand whether there are any plans to award discretionary pension increases to scheme members, and the potential cash and accounting implications if so.
- Consider the cash and accounting implications of any buy-in / buy-out transactions being planned to take advantage of favourable insurer pricing and improved surpluses.
- Review the position on recognising surpluses and consider obtaining legal advice to remove any uncertainty in this area, given the increased incidence of large surpluses (if not already done previously).
- Consider updating longevity assumptions for ongoing mortality trends given higher-than-typical mortality rates.
- Consider the implications of the Virgin Media ruling for your scheme and the appropriate accounting treatment and disclosure.

Credit insurance

What's new

Credit insurance will be present somewhere in the supply chain as there is £350bn of insured trade in the UK across 630,000 businesses. In 2023 we saw some large company failures in the construction sector, where the credit insurers and Sureties received significant claims. Sureties in particular now have minimal appetite for providing performance bonds for construction contracts and credit insurers are looking to reduce their exposure. Other sectors on watch include, retail (some big failures already this year such as The Body Shop and Ted Baker), hospitality and leisure, technology and transport and logistics. It is crucial for businesses to assess their payment performance and understand the impact of any possible reductions or withdrawals of credit insurance cover on their working capital.

Key reminders and governance considerations

If insuring against debtor default

- Engagement with insurers should be a regular thing - at least every six months for any limits <£1m and every two months for limits >£1m.
- What is the risk profile of the customer base? How much of their income is derived from sectors that are at risk?
- Have they had to report debtor late payments to insurers? If so, that could trigger a reduction in cover / credit limits. We have started to see this as insurers become more proactive in managing risk.
- What credit limits do companies have across their portfolio and is there any headroom to provide capacity if there are reductions? What limits are actually needed?
- The effect on sales if terms have to be reduced due to reductions in credit insurance limits. How will they remain competitive?

If their suppliers have insured against them defaulting

- What their credit ratings are across several different agencies – this is the starting point for insurers when assessing risk.
- What is their payment performance like? Are they asking for extended payment terms? If so, suppliers have a duty to report both to their insurer which will raise the risk levels potentially. Insurers are seeing late payment as a trigger for reduction in cover / limits.
- Is there a possibility that accounting periods will be extended?
- How will year end results compare to peers?
- Engagement with insurers – insurers want access to regular MI and any reticence in engaging and providing information will raise a red flag.
- Understanding which suppliers have credit insurance (this can be difficult as most policies have a confidentiality clause but a good relationship with suppliers should help).
- If there is a reduction or withdrawal of credit limits and suppliers have to reduce terms, what will the impact be on their working capital – if they have to pay suppliers up front it could significantly impact cash flow. Is there any headroom?
- What levers do companies have with key suppliers to negate any removal or reduction in credit limits by the insurers? Are they a big enough customer for the supplier to negotiate? Could they source elsewhere? Can they tie the supplier in?

What actions should corporates take / consider

- Review your own credit reputation – this will help with understanding whether suppliers are likely to struggle to obtain credit for trade. Has there been any negative press coverage for example? Are suppliers being paid to terms or stretched?
- Make sure you deal with any statutory demands or winding up petitions promptly. These have been factors in most insolvency cases recently and are a real red flag for suppliers and credit insurers.
- Pay attention to supply chain risks – no business exists in isolation.
- Know your customers, yes, but the same applies to suppliers.
- Review key suppliers for trading terms and trade levels. What would the impact be if terms were reduced? Are you using all of the credit limit?
- How quickly could you respond to requests for key MI?
- In person engagement – be that with customers, suppliers or credit insurers – build a relationship which will sustain in difficult times.

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Thank You