FRC Review of corporate governance reporting 2024

KPMG Board Leadership Centre

The Financial Reporting Council (FRC) has published its Annual Review of Corporate Governance Reporting 2024, providing important insights as companies prepare to implement the revised UK Corporate Governance Code from January 2025. The review provides an overview of corporate governance reporting based on the annual reports of a sample of 100 randomly selected FTSE 100, FTSE 250 and Small Cap companies that follow the UK Corporate Governance Code. However, given the focus this year on risk management and internal control, the FRC have examined this area in more depth and considered the annual reports of 130 companies.

Code compliance

The review emphasises the continued importance of the Code's 'comply or explain' approach, which allows companies to depart from provisions when circumstances warrant, provided they offer high-quality explanations for their alternative approach. While companies are making good use of this flexibility, the FRC notes that the quality of explanations for departures could still be improved and urges investors, proxy advisors and service providers to support those companies that provide cogent explanations that demonstrate good governance.

Key message

There is no single approach for how companies report their compliance with the Code. However, good reporting helps a reader to understand how the company has applied the principles and determine whether it has complied with all the provisions of the Code. If the company has not, it also informs readers which provision the company has not complied with, and where to find the explanation for this.

Corporate culture

Disclosure of corporate culture continues to evolve. While the breadth of reporting has widened, the FRC have found that depth is lagging and, in some cases, for example, culture assessment and monitoring, has decreased.

On the positive side, over 20 companies disclosed a clear set of culture metrics and targets. In addition, the FRC found that more companies this year also reported on progress against those targets

Key messages

- Disclosure in governance reports around how boards are promoting the desired culture is generally very low. More thorough reporting in this area and better signposting in the strategic report, where most of culture reporting is usually placed, is urged.
- While reporting on culture assessment and monitoring keeps increasing, this year more companies opted for disclosure of policies and practices, rather than board's actions during the year. The FRC encourage more transparency and rigour in reporting.

Shareholder engagement

The FRC are pleased to see that all companies reported on engaging with their shareholders during the reporting year, with 97 reporting on engagement that occurred outside of the AGM. However, like in previous years, they found little improvement in the quality of reporting on shareholder engagement. Most companies offered few details on the engagement, feedback received from shareholders or examples of outcomes.

Key message

Explaining the outcome of engagement activities with shareholders adds meaning and purpose to reporting, although it is understood that outcomes can take time to materialise.

Stakeholder and workforce engagement

While reporting on engagement is generally high quality, the FRC note that it is sometimes unclear how the board specifically (rather than management or other employees) engages with different stakeholders.

The 2024 Code places greater emphasis on the importance of outcome-based reporting which the FRC hope will reduce boilerplate reporting and the length of annual reports.

Key message

To demonstrate the effectiveness of the engagement, it is important to explain the engagement undertaken during the year and any outcomes.

Over-boarding

While the 2024 Code consultation initially explored proposals in relation to 'over-boarding' – where directors' multiple board commitments potentially compromise their effectiveness – the FRC ultimately decided against implementing new requirements to avoid increasing reporting burdens. Nevertheless, the review did examine how companies currently address this issue in their annual reports.

Encouragingly, over 90% of companies sampled provided specific information on the external commitments of directors and over 65% listed all directors' other appointments. Most companies simply listed directors' external appointments in the directors' biographies section of the annual report. However, some companies provided specific information on their considerations of individual directors' time commitments and explained the actions taken to manage their time commitments.

One company disclosed its over-boarding policy which stipulates how many external appointments a NED should have. However, most companies were not as specific about their policies.

Key messages

- Companies are encouraged to be transparent in their annual report and disclose information about the time commitments of their directors.
- When calculating the expected time commitment, boards are advised to consider the additional commitment needed when the company is experiencing increased activity, for example during a period of distress, and the role that individual directors are likely to play on committees of the board, including possibly chairing these, .

Diversity

The approach to reporting on diversity policies varied. Some companies cited that they had diversity policies but did not provide a description of what the policy entails. Others gave generic descriptions of what their diversity policy includes without referencing any specific targets or objectives for how they aim to improve their diversity.

However, the FRC were encouraged to see many companies providing clear information about what their board diversity policy covers, their targets and objectives and the progress they have made to achieve these. Also, was encouraging to see some companies report on targets and initiatives for diversity characteristics beyond gender and ethnicity.

Key message

Many companies reporting clearly on their diversity and inclusion policies, and encouragingly some companies also explain diversity initiatives which they have put in place.

Audit

Following the 'Audit Committees and the External Audit: Minimum Standard' is currently voluntary. Nevertheless, many companies are already referring to it in their annual reports. A few companies reported that they already fully or partially follow the Minimum Standard. However, most companies examined by the FRC are at an earlier stage, which is understandable given the standard is not yet formally part of the Code.

Both the Minimum Standard and the Code cover tendering. The Minimum Standard specifies that challenger firms (non-Big Four) must be given fair and objective consideration. Encouragingly, several companies that tendered for external audit during the period, or will tender next year, have said that they take account of the Minimum Standard when tendering.

Key message

Early adoption of the Audit Committees and the External Audit: Minimum Standard (the Standard) is optimum because it facilitates timely design and testing of new processes and an evolutionary approach to enhancing audit committee practices, for example around audit tenders. Companies can support their audit committees by making their responsibility for following the Standard explicit in terms of reference. This is one of the ways that companies can encourage their audit committees to focus on the content of the Standard.

Audit Quality Review inspection results

The report considers how companies report on Audit Quality Reviews and found there has been an increase in the level of disclosure by audit committees of these inspection results. However, the FRC's review found several examples of no disclosure where they would have expected it. There were also several examples where the FRC felt the information given was not sufficiently clear or could be misinterpreted by the users of the annual report.

Key message

There has been an increase in the level of disclosure of AQR inspection results. There is room for improvement in the quality and clarity of the disclosures, to demonstrate how the work of audit committees supports overall improvements to audit quality.

Risk

When reporting on principal risks, good reporters provide a balanced overview of the most significant risks for the company, considering the impact if these risks materialised and the probability of them occurring. As in previous years, all the companies sampled described their principal risks and actions to manage or mitigate – and many companies provided high-quality reporting in this area.

Good reporting on principal risks demonstrates that risks are not static but shows how they have changed during the year, and over years. Most companies' descriptions of principal risks remained like the previous year although a few risk descriptions had been updated where changes had occurred. Companies were more likely to update their risk mitigations.

The FRC were encouraged to see that most companies indicated the residual risk profile change during the year – usually using a symbol to indicate whether the risk had stayed the same, increased or decreased. Better reporters in this area also included a description of how the risk had changed during the year.

Key message

Good reporting on principal risks is not static but shows how risks have changed during the year, and over years.

Risk Management and Internal Control

It is important that there is a robust annual process for the review of the effectiveness of risk management and internal control systems. This review must encompass all material controls, including financial, operational and compliance controls. Just under half of those sampled specifically stated that they reviewed their operational and compliance controls as part of their annual review of effectiveness.

Assurance

The Code is neutral regarding the sources of assurance commissioned by the board or the relevant board committee in assessing the effectiveness of risk management and internal controls systems. However, the review found that nearly all the companies sampled had an internal audit function and used this when carrying out a review of the effectiveness of the internal control systems. Good reporters explained the scope of the internal audit and how this work is communicated to the board and relevant committees.

Around a third of those sampled reported using the 'three lines of defence' model for risk management and internal control reviews. Most of these used internal audit as the third line of defence.

In terms of external audit, just over three-quarters of those sampled included the findings or input of the external audit in the review of effectiveness of risk management and internal control systems. The nature of the work undertaken by external audit was varied across the sample.

Examples include: 'Audited' financial controls (a requirement for US listed companies under the SOX); results and controls observations as part of the annual external audit; and specialist assurance over specific controls where the board has determined this is required

Reporting on the review of effectiveness of risk management and internal control systems

The Code asks boards to report on their review of the effectiveness of risk management and internal control systems. Just under half of the companies sampled reported on their review in some detail, including what areas were covered or a simple statement of who carried out the review – only 10 percent were categorised as examples of good reporting. The FRC determine that good reporting addresses the process of the review, including information on who carried out the review and what information was provided to the board or relevant committee. It should also explain which key or material controls were looked at, and from where the information on these controls was sourced.

Just over half of the companies sampled confirmed that a review had been carried out without providing further disclosures, did not mention the review, or were unclear in their reporting as to whether a review had been carried out. The FRC note that phrases such as 'The committee (or board) reviews the effectiveness of the risk management and internal controls framework' or 'review and challenge management's reports on the effectiveness of the internal control and risk management systems', do not provide readers of annual reports with information on what the review involved, nor how the board monitors the effectiveness of risk management and internal controls systems.

Reporting the outcome of the review of effectiveness of risk management and internal control systems

The report emphasises the importance of reporting the outcome or results of the review of the effectiveness of risk management and internal controls systems. This aspect of reporting will become even more critical from January 2026 onwards, when the outcome of the review will, under the revised 2024 Code, be reported by companies in the form of a declaration.

Of the 130 companies sampled:

- 23 stated that their systems were effective and that no weaknesses were identified
- 30 stated that their systems were effective
- 20 stated that no weaknesses were identified
- 7 only stated that their financial reporting controls were effective
- 16 identified weaknesses
- 34 did not report on the outcome

Key messages

- The board has ultimate responsibility for an organisation's overall approach to risk management and internal control.

- It is up to boards to determine whether they review the risk management and internal control systems more frequently than once a year. The aim of the review is to identify strengths, gaps, deficiencies and areas for improvement, and be followed up by a plan to take forward any actions.
- When reporting on the review, good disclosures provided a summary of how the board had monitored and reviewed the effectiveness of the framework. This could include the type of information the board has received and reviewed; who it has consulted with; any internal or external assurance received; and if relevant, the name of the framework, standard or guideline the board has used to review the effectiveness.
- With cyber incidents on the rise globally, it is good to see that almost 90% of companies sampled are treating cyber security as a principal risk.

Viability

The FRC assert that historically, viability reporting has been relatively poor, often with statements providing insufficient qualitative and quantitative information regarding the inputs and assumptions used.

Some sampled companies clearly undertook the recommended two-stage process for developing their viability statements, as per the FRC's guidance. These companies highlighted how they assessed their viability, referencing the scenarios considered and linking them to principal risks. Conversely, other companies provided only basic disclosures on the rationale behind the appropriateness of the assessment period.

Most of the sampled companies stated that they had modelled several scenarios which included inputs and assumptions with references to principal risks. The FRC consider that good reporters map this out within their statement illustrating what was modelled, references to assumptions and a clear link to the principal risks.

Around a third of those sampled noted the use of reverse stress tests. Often, disclosures related to reverse stress testing stated that they had been carried out, but little information was provided on the approach. Rather, there was a simplistic statement highlighting that the reverse stress test covered multiple concurrent risks. Details regarding the inputs and assumptions in relation to reverse stress testing were also lacking. Similarly, the disclosure of the outcomes of reverse stress testing could be improved and the FRC encourage companies to consider enhancing their disclosures by including this information in reference to the reverse stress test scenario.

Key message

The FRC believe there is significant scope for improvement in this area. By clearly outlining the rationale for the assessment period and providing longer -term information where possible, companies would offer valuable insights to investors. Additionally, including sufficient qualitative and quantitative information is crucial for enabling readers to fully understand the assessment.

The KPMG Board Leadership Centre

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