2018 Corporate governance code

On 16 July 2018 the Financial Reporting Council (FRC) published its long awaited update to the UK Corporate Governance Code together with revised Guidance on Board Effectiveness.

- The Code sets the standards of good practice for listed companies on shareholder relations, remuneration, board composition/development, accountability and audit.
- A concise version, Wates Corporate Governance Principles for Large Private Companies, is in consultation for private firms.

The revisions support the government's vision of restoring trust in the corporate organisations and the broader social reform agenda which aims to improve the standard of living and quality of life for ordinary working people.

In this paper, the Institute looks at the key changes and their relevance to internal auditors.

Summary of Changes

The business secretary, Greg Clark commented that *"these changes will drive improvements in how boardrooms engage with employees, customers and suppliers as well as shareholders, delivering better business performance and public confidence in the way businesses are run."*

A full summary of the changes is published by the FRC, in essence it is

- Shorter and easier to navigate
- Focused on the Principles
- Enhanced with new Principles on stakeholder engagement, alignment of strategy, culture and values, board responsibilities regarding workforce policies, refreshing the board and remuneration
- Less onerous (59 principles and provisions compared to 99 previously)

The five section headings have changed under which the Principles and Provisions are listed.

2016 Code		2018 Code	Principles
Leadership	1	**Board leadership and company purpose**	A-E
Effectiveness	2	**Division of responsibilities**	F-I
Accountability	3	**Composition, succession and evaluation**	J-L
Remuneration	4	**Audit, risk and internal control**	M-O
Relations with shareholders	5	**Remuneration**	P-R

Changes Specific to Internal Audit

Principle M *requires the board to establish formal and transparent policies and procedures to ensure the independence and effectiveness of internal and external audit functions and satisfy itself on the integrity* *of financial and narrative statements.*

- Chief audit executives (CAEs) without a direct reporting line to the audit committee should use this principle as a discussion lever to effect change with their audit committee chair. For additional information on what constitutes 'independence' refer to the International Professional Practices Framework (IPPF) Standard 1110.
- The principle also introduces formality to ensuring the effectiveness of internal audit that was missing from the previous Code. Again this is an area where the board may need support as to how they can achieve this with minimum effort given the limitations on their time. Audit leaders may wish to think about preparing a policy and approach for their audit committee building on existing practices and incorporating the IPPF which sets out ongoing review Standard 1300 (quality assurance improvement programme), internal assessment Standard 1311 and external assessment Standard 1312. Establishing KPIs to measure performance may also be useful.
- Finally CAEs must give consideration to the assurance provided over the narrative statements in the annual/interim report, reports to regulators, price-sensitive public records and other information required by statutory instruments. We come back to this in the Reporting section.

Supporting Principle M is **Provision 25** requiring the audit committee to monitor and review the effectiveness of the company's internal audit function or, where there is not one, considering annually whether there is a need for one and making a recommendation to the board.

- This is not new and some readers may be disappointed that the provision does not make internal audit compulsory. The Institute maintains open dialogue on this point. It therefore remains incumbent on the internal audit profession to educate and support audit committee chairs on the value that internal audit delivers. CAEs should not take for granted that whilst their organisation currently has an internal audit function; it can be outsourced or removed with reasonable explanation due to budget constraints, downsizing etc.
- Whether supplemented by formal processes or not, the audit committee forms its opinion of internal audit effectiveness through ongoing dialogue with the chief audit executive and the board/senior management together with the content and presentation of regular reports. Audit leaders may find this an opportune time to evaluate their relationships and review their audit committee reporting; its frequency, content, format and readability. Does it provide insight and information or data? Does it generate meaningful discussion or is it largely nodded through the agenda? Does it inspire confidence in the function?

Whilst the revisions do not yet make internal audit compulsory, principle M heightens the profile of internal audit within these requirements by positioning it alongside external audit.

Impact on internal audit activity

Some of the new principles and provisions have a direct bearing on the activities of internal audit. For some functions these may already be regular features on the audit plan, for others ad-hoc engagements….going forward all CAEs will need to be thinking about them.

Narrative Statements

Referring to **Principle M**, while external audit scrutinise the financial statements, internal audit can offer valuable assurance to the non-executives over the narrative statements. There is a real desire in the 2018 Code for non-executives to understand how the organisation operates and internal audit has a key role in this. Management may be tempted or pressured to present a view of the organisation that fits the 'ideal' rather than the 'reality'. How would non-executives know? There are various shades of poetic licence in writing strategic reports and independent assurance is essential.

Reporting should demonstrate how the organisations governance contributes to its long-term viability, achievement of goals, objectives and social responsibilities. Stakeholders should be able to evaluate compliance themselves through tangible, evidenced reporting rather than rely on vague statements that could apply to any organisation. Tick box reporting should not be tolerated.

What role does your function currently have in this space? Which data sets present the highest risk for misreporting? Do the principal risks adequately represent those that the organisation faces? How can assurance be provided without delaying publication? CAEs cannot avoid these challenges. Narrative statement assurance must be on the audit plan.

The FRC has stated its intent to escalate monitoring of practice and reporting. Internal auditors may feel it prudent to prepare themselves and their Boards for this extending beyond financial reporting and audit enforcement procedures into the broader Principles.

The collapse of construction giant Carillion happened during the consultation period for the 2018 Code. It should come as no surprise to internal auditors that whilst most of the audit, risk and internal control section remain unchanged, the expectation of how risk is managed has increased.

Provision 28 now states that the *board should carry out a robust assessment of the company's emerging and principal risks*. And report on them.

It is unlikely that board discussions have not included emerging risks, however, it is equally unlikely that they are publicly disclosed. CAEs will need to be sensitive as to the balance between transparency and commercial confidence when providing narrative assurance. Many organisations have risk committees (a requirement in financial services) and internal audit should provide assurance over their remit, composition, skills and service quality.

Corporate Culture

The new Code states that a company's culture should promote integrity and openness, value diversity and be responsive to the views of shareholders and wider stakeholders; in the wake of scandals this clearly aims to rebuild corporate trust.

Principle B states that the board should establish the company's purpose, values and strategy, and satisfy itself that these and its culture are aligned. All directors must act with integrity, lead by example and promote the desired culture.

Provision 2 requires the board to assess and monitor culture, where it is failing to seek assurance that management has taken corrective action and report on it in the annual report.

Where will the audit committee seek such assurance? How will internal audit know that management need to take action? Audit committees should be discussing this with internal audit. They should be challenging CAEs that have made no provision for assurance on culture. Whether specific audits, integrated into all audits or following up on specific actions, it must be addressed.

Sources of culture insights

- Turnover and absenteeism rates
- Training data
- Recruitment, reward and promotion decisions
- Use of non-disclosure agreements
- Whistleblowing, grievance and 'speak-up' data
- Employee surveys
- Board interaction with senior management and workforce
- Health and safety data, including near misses
- Promptness of payments to suppliers
- Attitudes to regulators, internal audit and employees
- Exit interviews

Extract from 2018 FRC Guidance on Board Effectiveness

Audit leaders have long recognised the significance of culture to organisational success and there is a variety of guidance on auditing culture on the Institutes website together with a research report. As a minimum CAEs should consider their assurance provision over the sources that boards are being encouraged to look at by the FRC.

Workforce Policies

Principle E states that the board should ensure that workforce policies and practices are consistent with the company's values and support its long-term sustainable success. The workforce should be able to raise any matters of concern.

Workforce is defined very broadly in the Guidance on Board Effectiveness, including zero-hours contracts and could be interpreted to include those not directly employed by the organisation such as agency workers or third-party arrangements.

Internal audit assurance over such policies and practices, particularly during periods of change, may become a frequent feature of audit plans. CAEs may also consider engaging with the HR leadership team on a regular basis to stay abreast of developments if this is not already a key relationship.

The ability of the workforce to raise concerns is not new, it is one of the aspects of a good culture, however the 2018 Code does not limit this to financial reporting matters. Audit plans should already provide assurance as required over the effectiveness and efficiency of tools such as whistleblowing programmes.

Provision 5 specifies that for engagement with the workforce one or more of three approaches should be adopted. Organisations must justify the use of alternatives.

- a director appointed from the workforce
- a formal workforce advisory panel
- a designated non-executive director

CAEs may wish to consider reviewing the process by which the decision is made, the information used, the stakeholders involved and the rationale. How has the diversity of the workforce been considered, particularly across geographies and cultures? As with auditing strategy it is not the outcome that is subject to scrutiny but the decision-making process itself. In future years, internal audit is the only function positioned to independently evaluate the effectiveness of such arrangements and facilitate change where necessary.

The new Code puts great emphasis on all stakeholder relations, not just those of the workforce. CAEs should consider their assurance activities for sources that the board may seek out based on FRC guidance.

Sources of stakeholder insights

- Contacts with key customers
- Customer complaints and satisfaction data
- Supplier feedback
- Surveys
- Social media
- Bespoke engagement activities on specific issues, for example, with trade unions, special interest groups or the local community

Extract from 2018 FRC Guidance on Board Effectiveness

Risk Management

Provision 28 now states that the board should carry out a robust assessment of the company's emerging and principal risks.

Assurance over the effectiveness of risk management may vary depending on the existence of a 2nd line risk function, its maturity or its integration into the internal audit remit. Regardless, one aspect that should now feature is the process by which emerging risks are identified, assessed/prioritised and managed. Both principal and *emerging* risks are now required to be reported on publically, heightening the profile of the robustness of the processes supporting their disclosure.

Board Refreshment

Subtle changes in emphasis and new provisions are designed to minimise the stagnation of boards and encourage diversity:

- Provision 7 obliges conflicts of interest to be identified and addressed;
- Provision 15 addresses the risks of '*overboarding*' (being on too many boards);
- Provision19 limits the tenure of the chair (the chair should not remain in post beyond nine years from the date of their first appointment to the board);
- Principle J promotes diversity by basing appointments on merit; and
- Principle K requires boards to consider their combination of skills, knowledge and tenure.

Board evaluation is not a new concept; although it is rarely undertaken by internal audit. Could internal audit have a role in assuring the board over their processes such as appointments and succession planning for example? Does this have to be outsourced to external consultants? Would more frequent assurance be beneficial to boards going through change?

Companies outside FTSE350

The Code has always included exemptions for certain requirements for small companies. The draft proposed to remove all exemptions. Only one exemption has been removed from 2018 Code. All companies will now need to make arrangements for annual re-election of directors if they are not already doing so.

Additional Reporting Requirement

Alongside the new Code, a new regulation was also published Companies (Miscellaneous Reporting) Regulations 2018 enforcing reporting requirements for section 172 of the Companies Act 2006.

Subject to parliamentary approval, these new reporting requirements will applies to all companies that prepare a strategic report. This will also take effect 1 January 2019.

Some aspects enhance existing requirements or are straightforward narratives, however, there are also two new disclosures which internal audit should consider for assurance purposes.

- **Publication of CEO's pay ratio**; the CEO's total remuneration to the 25th, 50th and 75th quartile pay remuneration of UK employees.
- **Share price impact reporting**; additional provisions in directors' remuneration report.

Whilst external audit will undoubtedly validate the calculations, internal audit may be required to provide assurance over the completeness, relevance and timeliness of the data used.

Closing Thoughts

The 2018 Code provides numerous opportunities for audit leaders to engage with the board/audit committee and demonstrate the value that internal audit can bring to an organisation. From culture to pay ratios, board appointments to emerging risks, internal audit has a role to play. The question is….are you ready to learn the lines and take centre stage?

> *This new code, in its shorter and sharper form, and with its overarching theme of trust, is paramount in promoting transparency and integrity in business for society as a whole*
> *Sir Win Bischoff, FRC Chair*