Governance *in focus*
Audit committees and the 2015 reporting season – year end briefing

The Deloitte Academy

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Contents

Audit committees and the 2015 reporting season – year end briefing

Introduction

In this Governance in focus, we look at the areas audit committees need to be focussing on as we head into this reporting season, including: increasing responsibilities and expectations on risk management and internal control, the areas of focus from the FRC's Corporate Reporting Review, significant upcoming changes to reporting of taxation, effective audit committee reporting plus an indication of key governance themes for 2016.

This is designed to be a year end round-up, but this has been a busy year on the governance front, so it is somewhat lengthy. Where further reading is recommended, we have included references to our governance briefings which provide a deeper dive and links to other resources.

Do get in touch with your Deloitte partner or the Deloitte governance team if you would like to discuss any areas in more detail. And don't forget you can join us at the Deloitte Academy where we host live updates which allow you the opportunity to air current issues and swap notes with your peers – even more useful at a time of great change.

In this document…

Raising the bar on risk management and internal control	The new requirements raise the level of challenge the audit committee should pose in its review of risk management and internal control systems including the new board requirement to monitor material controls. This area is new and therefore will be reviewed with great interest, but even more so with the level of technology disruption to business models and the increase in cyber attacks. We set out the key matters audit committees need to consider.
The longer term viability statement	The longer term viability statement is an opportunity for boards to draw together certain aspects of the annual report, linking strategy and business model disclosures and the principal risks in the front half with the financing pages in the back half. We describe the key decision points along this journey.
Taxation	The OECD's global tax reset project (base erosion and profit shifting (BEPS)) will bring a seismic change in the coming year. In the UK, HMRC has published its own consultation on the publication of tax strategy for multinationals. We touch on the key aspects.
Key areas of focus for this year's annual report	The FRC's Corporate Reporting Review team has issued its latest report highlighting key areas of focus for this year's annual report. We provide an overview for audit committees when reviewing company reports this year end. We have recently issued our Annual Report Insights 2015 based on a survey of 100 listed company annual reports. The full report contains good practice examples and tips for improving your annual report. In this document we touch on some key findings.
Audit market developments	We provide a summary of the latest position on implementation of the EU Regulation and Directive, including the clarification of transitional provisions on auditor rotation and tendering issued by BIS, non-audit services restrictions and the 70% cap on non-audit fees.
Governance hot topics for 2016	In order to help you fulfil your broader role as a board member, we highlight a number of other key themes for 2016.

Raising the bar on risk management and internal control

Governance *in focus*
Risk management: getting your house in order

The board and audit committee must agree their respective roles in the risk and control agenda
The 2014 UK Corporate Governance Code raises the bar for boards on risk management and internal control, but what does this mean for audit committees?

The board now needs to provide a statement in the annual report that it has carried out a robust assessment of the principal risks to the business, including those relating to solvency and liquidity. In addition the board is responsible for monitoring the risk management and material controls on an ongoing basis rather than once a year.

Whilst the board has overall responsibility for determining risk appetite and risk identification and assessment, it is the audit committee's responsibility to review the effectiveness of the company's risk management and internal control systems unless a separate board risk committee comprised of independent directors has been introduced for that purpose, or the board addresses the matter in plenary.

Matters for audit committee consideration

- Has the company's appetite for risk been considered at board level and is it clearly related to the company's objectives, strategy and business model?
- Has the board got the principal risks right and are they being regularly re-evaluated?
- How robust is the assessment? What process has been followed?
- Has the authority, responsibility and accountability for risk management and internal control throughout the company been appropriately documented in a tool such as a risk dashboard? Is there a clear owner for each of the principal risks?
- Have all material controls been identified? A good starting point for this might be the controls and mitigati-ng activities over the principal risks and the delegated authorities matrix.
- Is the description of how principal risks are being managed or mitigated giving a misleading impression?
- Is the internal audit annual plan addressing the right risks and controls? Are all principal risks and material controls covered during the annual cycle?
- Have necessary actions been taken promptly to remedy any significant failings or weaknesses? What were the root causes?
- Do the causes of the failing or weakness indicate poor decision-taking, a need for more extensive monitoring or re-assessment of the effectiveness of management's ongoing processes?

Providing better information for investors about the board's stewardship is a key part of the new Code provisions – the previous year's risk management and internal control system disclosures will need to be revisited to provide clarity on the risk assessment process undertaken by the board and on the monitoring role carried out by the board.

Deloitte view
The best audit committees will be well on top of these significant Code provision changes, but less well-resourced companies may not be as far advanced as they would like.

It is broadly recognised that the disclosures will be of great interest to investors, and companies in the same sector are likely to be compared.

Be careful with the disclosures – this is “a journey” and many companies will need to enhance their risk management processes. There should be robust challenge of the statements being made around the organisation’s approach to risk and mitigation activities – are they really effective? Do they give a misleading impression? This is particularly important in cases such as cyber.

Remember, the auditors have responsibilities to report if they have anything material to add – so early engagement on auditors’ expectations would be beneficial. With the increased focus on risk management and internal control, there is a reputational risk for the audit committee to consider – if an unreported risk causes business problems, questions could well be asked about the quality of the governance processes and the audit committee’s oversight.

Cyber – the risk on everyone’s mind at present
Questions the audit committee should be asking:

Robust assessment of the risk

- What is the potential impact on our company of a cyber attack? How was this assessed?
- Have we identified our key information assets and systems?
- Have we assessed the consequential impact of cyber attack?
- How resilient is our technology architecture?

Management and mitigation activity

- Do we have appropriate policies and procedures in place?
- How do we ensure that our employees, including the Board, are appropriately trained regarding cyber risks and their responsibilities?
- Do we have appropriate technology defences and detection systems? Are they tested?
- What incident management plans do we have in place, and how often do we test these?

Monitoring of internal controls and review of effectiveness

- Who owns the risks associated with cyber threats?
- Are controls effective? What independent assurance do we have of this?
- What monitoring is performed of material controls at board level in this area?
- What assurance do we receive on our information and data security, has it been reviewed against an external framework like UK Government’s “10 Steps to Cyber Security” or the US “NIST Cybersecurity Framework”?
- What independent review is done by both internal and external auditors?

The longer term viability statement

Governance *in brief*
– The longer term
viability statement
– a "how to"
summary guide

Viability is based on the robust assessment of principal risks

Directly following the UK Corporate Governance Code provision on the robust risk assessment, Code provision C.2.2 requires the directors to state whether "they have a reasonable expectation that the company will be able to continue in operation and meet its liabilities as they fall due over the period of their assessment, drawing attention to any qualifications or assumptions as necessary."

Five key decisions

In preparing the longer term viability statement, the board will need to take **five** key decisions:

1 Choice of "lookout" period	There is no expectation that boards should be inventing some new planning process or period to meet this Code provision (unless, of course, one is needed anyway). Some companies prepare short, medium and long term "forward look" plans – there should be no problem with basing the viability statement on the medium term plan which would carry a greater confidence level than long term plans, if the period can be justified. It is also worth bearing in mind that inevitably here also investors and other observers will do an element of sectoral comparison. Early adopters of the longer term viability statement disclosure have reported three (i.e. 1+2) or five year (1+4) lookout periods. We expect the majority of companies to fall within this range, in line with their medium term plans.
2 The principal risks to be factored into the analysis	This builds on the requirement for boards to make a statement that they have carried out a robust assessment of principal risks, to describe them and how they are mitigated. Practically, for the viability statement, directors have to decide whether principal risks need to have their impact quantified and possible timing determined in order to inform any stress testing they may require for their assessment.
3 The nature and extent of supporting analysis	Broadly there are three different levels of analysis: • Qualitative analysis – Low complexity and low data requirements but likely to be insufficiently robust. • Scenario planning – Medium complexity and medium data requirements, this is likely to be the most used level of analysis outside of financial services. • Modelling – High complexity and high data requirements – allows for the development of "at risk" measures for individual risks and combinations of risk. The board should consider where on this spectrum it would like to land and perhaps consider whether the ultimate aim should be to develop a more sophisticated modelling process in the future.
4 Qualifications and assumptions	The board should draw attention to any qualifications or assumptions it believes necessary. These will be those material factors underpinning the viability statement that investors need to know. Some companies are cross-referring to all principal risks. The descriptions should be specific to the circumstances of the company and should focus on those qualifications and assumptions which are the most significant to the prospects of the company.
5 Location of the statement	Early adopters have included the statement in the strategic report, in the corporate governance statement or in the directors' report. The location is up to the board but given that the longer term viability statement is underpinned by the robust assessment of principal risks, our suggestion is for it to be included with or near the principal risks and risk management disclosures in the strategic report.

The audit committee's role

To have real business benefit, the process behind the longer term viability statement should be robust. There is no requirement to disclose detail about the process, but if viability statement activities have been delegated to the audit committee, the audit committee's report might consider explaining:

- which responsibilities have been delegated to the audit committee or risk committee;
- any changes made to the risk management and internal control processes in order to ensure sufficient good quality information is available for the longer term viability statement;
- the process behind determining which principal risks are the most relevant and could have the most impact on financing arrangements;
- whether additional rigour has been applied to scenario planning or sensitivity analysis – we expect this will have been enhanced by many companies;
- the timetable imposed on the process to consider the longer term viability of the company, any additional meetings held or sub-committees formed and who has been involved in the process;
- any involvement of external advisers or specialists; and
- finally (and least important) any additional processes around making the statement, such as consideration in disclosure committees.

Deloitte view

The overriding driver of the new longer term viability statement is to provide shareholders with a clearer understanding of the way the board is managing the principal risks to their invested capital over the medium term.

The statement presents an opportunity to draw together key elements of the annual report, from the business model disclosures and the principal risks in the front half to the financing disclosures in the back half.

Remember, here again the auditors have responsibilities to report if they have anything material to add – so early engagement on auditors' expectations would be beneficial.

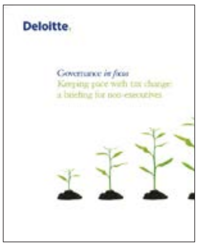
Auditor reporting requirements to shareholders

The auditors have significant new responsibilities to report to shareholders in relation to aspects of the directors' disclosures on risk management and the longer term viability statement.

First, auditors must review the statement for consistency with other knowledge they have acquired during the audit, including the assessment of going concern, and whether the disclosures are in harmony with the overall requirement for the annual report to be fair, balanced and understandable.

Second, auditors have a significant new requirement to report in the audit report whether there is anything material to add or draw attention to in respect of the directors' confirmation that they have carried out a robust assessment of principal risks; the disclosures that describe those risks and how they are being managed or mitigated; the going concern statement and the longer term viability statement.

Taxation



Governance *in focus* – Keeping pace with tax change: a briefing for non-executives

International corporate taxation will see major change in the relatively near future. Most boards have been reviewing tax strategy in the light of public perceptions and recent changes in the law. However, the OECD changes being adopted in the UK in 2016 and subsequent years will change the tax landscape in a meaningful manner and will require action by many companies.

Base erosion and profit shifting

A global tax reset is underway: In 2013 the G20 engaged the OECD to address perceived inequities and inconsistencies in the global tax landscape; in particular, the perception that existing rules give businesses too much opportunity for arbitrage of tax rates and regimes. The OECD recommendations have become known as the Base Erosion and Profit Shifting (BEPS) Action Plan.

The UK government has indicated that it wants to be on the front foot bringing in relevant legislation and has already taken steps to implement new tax rules, including legislative change and several consultations. The changes include:

- requiring the largest UK multinational corporations to provide HM Revenue & Customs (HMRC) with country-by-country reporting with detail for each country in which they do business – companies will need to report for the financial year commencing on or after 1 January 2016 and have a year to produce the information following the year end;

- amending the UK's patent box regime to bring it in line with OECD/G20 recommendations – the existing patent box regime will close to new entrants on 30 June 2016, although existing claimants will be able to benefit from the existing regime for several more years;

- neutralising hybrid mismatch arrangements (arrangements which exploit differences between countries' tax rules to avoid paying tax or to claim excessive tax relief) – payments made from 1 January 2017; and

- limiting deductions for interest expense – the consultation document indicates this is unlikely to take effect any earlier than 1 April 2017.

The UK has also taken unilateral actions related to the BEPS agenda – for example, introducing a diverted profits tax of 25% to counter the use of certain aggressive tax planning techniques aimed at shifting profits to lower tax rate jurisdictions, which took effect for profits arising on or after 1 April 2015.

Companies that believe they may be affected by these measures other than administratively will need to consider how best to flag to investors that there will be a change in taxation affecting the company.

Improving large business tax compliance

HMRC's consultation on this topic closed on 14 October 2015 and we expect many of the proposals to become law in 2016.

The key areas of proposed change are:

- legislation compelling companies to publish their UK tax strategy;

- introducing a code of practice on taxation for companies; and

- bringing in a "special measures" regime for businesses considered to represent a significant "risk to the Exchequer".

If the final rules follow the proposals set out in the consultation then companies would be required to publish their UK tax strategy annually and a member of the executive board would need to "formalise, articulate and own" the tax strategy. Proposed disclosures include an overview of tax governance, the company's approach to tax risk management, tax planning and managing the relationship with HMRC, together with stating any "target" effective tax rate the company has and measures they have put in place to achieve this. There is no proposed requirement for companies to make public details of the profit or taxes paid by country. Companies should, however, bear in mind that the European Commission consulted over the Summer on proposals to mandate so-called public country-by-country reporting, with its conclusion expected in the first quarter of 2016.

The proposed code of practice on taxation covers "best practice" behaviours that HMRC would advise (but not mandate) all large businesses to adopt. It will consider whether companies are a signatory when conducting its risk assessment of the company. The code of practice is distinct from the Banking Code of Practice and covers three broad areas of behaviour:

- openness and relationship with HMRC;
- internal governance; and
- approach to tax planning.

There is no plan to publish a list of signatories to the code of practice on taxation.

Deloitte view
Where companies will be impacted by the OECD/G20 BEPS proposals or diverted profits tax, and there is no current disclosure in the annual report, there is a risk of concern when analysts become aware of increased taxes. Communications on changes in effective tax rate should be planned early and addressed in a straightforward manner to avoid any appearance of impropriety.

Multinational companies should start preparing now to meet the burden of additional administrative requirements for country-by-country reporting to HMRC. This could involve substantial manual information gathering where systems are not geared up to provide the relevant information automatically and it will ease the burden to develop a robust process and associated controls sooner rather than later.

Key areas of focus for this year's annual report

Governance *in brief* –
CRR annual report

The FRC's Corporate Reporting Review

Summary

In October 2015, the FRC published the 2015 Corporate Reporting Review (CRR) and set out areas of focus for the coming reporting season. These include more balance in the strategic report, more careful presentation of exceptional items, and more tailoring of disclosures of judgements and accounting policies. It is clear that the reviews are becoming increasingly sophisticated and are drawing on many sources of information when they consider the disclosures made in the annual report. This re-emphasises the need for boards to consider carefully the story being told and whether it is consistent throughout the annual report, with previous company announcements made and information presented elsewhere such as on the company website.

Common findings from the review

There were ten areas of corporate reporting raised frequently with companies during the year – on substantially similar themes to the areas raised most frequently in 2014. For all of these, but especially where boards and audit committees conclude on accounting errors or omitted disclosures, the FRC calls for detailed and appropriate consideration of materiality and transparent reporting by boards, with particular focus on items that could be qualitatively material for investors or other users of financial statements.

- **Strategic reports** should be fair, balanced and comprehensive, with suitable prominence given to IFRS measures alongside alternative performance measures. Boards are encouraged to focus on disclosures that are relevant to investors and not include extraneous material in their reports. Disclosures should be consistent with and reflect the company's business model and any unusual or non-recurring items should be explained.

- Completeness of **accounting policies**, which should include policies for all material transactions, including unusual or company-specific transactions, avoid the use of jargon and provide clear disclosures on development cost capitalisation, where relevant. Again, consistency with the business model was raised. For example, if the business model includes distinct and significant revenue streams, the FRC would expect to see accounting policies relevant to each revenue stream.

- **Critical judgements** made by the board in applying accounting policies should be explained clearly and judgements areas should be identified separately from accounting estimates. The quality of narrative disclosure in the accounts should be as high a standard as the quality of discussion around significant issues in the Audit Committee report.

- Cutting clutter is a serious area of focus for the FRC and companies should not include irrelevant information in the accounts. Many companies would benefit from a specific **"Clear and Concise"** review. When considering clear and concise reporting, boards should consider the investor and stakeholder perspective.

- The FRC continues to focus on the completeness of identification of separate intangible assets acquired in **business combinations**, looking in particular for consistency between discussions in press notices and strategic reports and intangible assets recognised in the financial statements. Boards need the right level of resource and expertise to identify and measure intangible assets arising from business combinations and the FRC recommends that companies should consider using external advisors for support. A recurring theme in press notices issued by the FRC this year was failure to properly identify transactions as reverse acquisitions, highlighting the importance of careful consideration of which party should be identified as the acquirer in a business combination.

- **Exceptional and similar items** remain a common finding – as before, this year the CRR also identified inconsistent presentation of non-recurring expense and income, the absence of accounting policies for exceptional items and the same "non-recurring" items arising in consecutive years.

- **Revenue** is a key area of focus for investors and some companies continue to have boilerplate accounting policy disclosures that do not address all material revenue streams described in their business model descriptions. A common finding is inadequate explanation of how companies estimate the stage of completion of long-term contracts.

- On **pension accounting**, policies have been found unclear and areas of focus included the disclosure of the accounting judgements made when assessing trustees' rights and disclosure of sensitivity analysis.

- On tax, disclosures around the reconciliation between a company's notional and effective tax rate need to be enhanced as well as **tax accounting** on share-based payments. The FRC also noted errors in tax calculations and disclosures prepared by external advisers and remind boards that they retain ultimate responsibility for this work and need to have robust procedures in place to assess the quality of information received from outsourced providers.

- The cash flow statement receives continued focus, including the classification of **cash flows** as operating, financing or investing and inappropriate netting of cash flows.

Areas of future focus

The corporate reporting environment is mature, with few new standards being introduced and boards are largely familiar with IFRS requirements and application. The 2016 reporting season areas of focus will be driven by macro-economic factors, including:

- Volatility in commodity prices and in equity and bond markets which may affect **asset valuations**, including appropriate disclosures of measurement sensitivity and impact on goodwill impairments in certain industries.

- Global and national focus on taxation could increase **tax uncertainties**, leading to an increasing focus on disclosure of accounting policies, tax risks and tax estimates.

There will also be focus on evaluating significant accounting judgements that are specific to each company and are important to investors. Boards are also encouraged to consider both the quantitative and qualitative aspects of materiality and whether issues are relevant to investors even if they do not meet a quantitative threshold.

Deloitte view

The publication of the CRR provides a timely reminder and enables companies to focus on the matters mentioned well in advance of December year ends.

In addition to the matters signalled, the new disclosures on risk and viability statements will also receive attention in 2016.

Upcoming changes to revenue recognition

A reminder

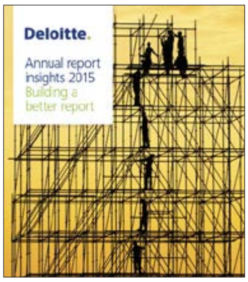
IFRS 15, *Revenue from Contracts with Customers*, was issued in May 2014 and has been the subject of much debate and significant amounts of work in certain industry sectors. The standard provides a single, principles-based five-step model to be applied to all contracts with customers in order to recognise revenue, as well as mandating more informative and relevant disclosures.

The effective date has now been deferred by one year to 2018 by an amendment to the standard issued by the International Accounting Standards Board (IASB) on 11 September 2015. Companies continue to have the option to apply the standard early.

Deloitte view

This standard is a significant one for many companies. Preparing for it may require not only changes in thinking and business process, but may also require changes in systems and have a knock-on effect on financing agreements, remuneration and other areas. In our view now is not the time to lose focus on the requirements of IFRS 15 – this deferral only gives a little more breathing space to address potentially significant issues.

Deloitte's Annual Report Insights 2015



Deloitte Annual Report Insights 2015

Summary

As in previous years, Deloitte has undertaken a comprehensive survey of 100 listed UK companies' annual reports, reviewing, amongst other things, disclosures on KPIs, risks, corporate governance, audit committee reporting and non-GAAP measures. The full survey, Building a better report, is available from www.deloitte.co.uk/annualreportinsights together with a highlights document which includes ideas on how to improve annual reports in the upcoming reporting season as well as identifying some key pitfalls to avoid.

Report length and content structure

10%
demonstrated comprehensive linkage

54%
gave non GAAP measures more prominence than the associated GAAP measures

16
of the companies in our survey clearly indicated that certain disclosures had been omitted from the financial statements on the basis of materiality

57%
of companies illustrated their business model with a diagram, only 2/3 of these diagrams made the model more understandable

Reporting on principal risks

only **35%**
of the companies we surveyed provided an indication of the change in the level of risk from the prior year

27%
of the companies we surveyed clearly indicated which strategy elements each of their risks related to

only **32%**
of the companies in our survey referred to the Board's involvement in activities around cyber risks and security within their corporate governance statements

Audit committee reporting

One of the key roles of the audit committee remains their work around significant issues relating to financial reporting – consistency and clarity in this area is key.

4 Average number of significant issues discussed in the Audit Committee report

48 audit committees discussed significant issues not disclosed as risks by the auditor

22% gave comprehensive disclosures of the significant issues

Most common issues discussed by the audit committee and not by the auditor:

12 going concern

10 identification and disclosure of exceptional or non-recurring items

10 provisions for a variety of exposures

Audit market developments

Governance *in brief* –
FRC consultation on
EU Audit Regulation
and Directive

The Audit Regulation and Directive is large and complex. We are working closely with professional bodies to make sure the new regulatory regime works as effectively as possible. We must ensure that it builds on the progress made in the UK in recent years in terms of the quality of audit, that competition in the audit market is strengthened in a way that supports innovation and that the regulatory regime that emerges provides confidence to investors and to firms by being fair, understandable and independent.

Stephen Haddrill, FRC Chief Executive

What's new?

- The Competition and Markets Authority's Order (the CMA Order) came into force for periods commencing on or after 1 January 2015. Audit committees should consider whether their terms of reference have been appropriately updated.
- BIS issued supplementary information relating to the framework for auditor tendering and rotation, developed in collaboration with the FRC and the CMA, which clarified tendering and rotation timelines.
- The FRC and BIS both consulted on the principles for implementation and are now consulting on detailed changes to legislation, the Code, the Guidance on audit committees, auditing standards and ethical standards for auditors – these close in December.

Audit tendering and rotation

For a public interest entity (PIE)[1], there should be a competitive tender process at least every ten years and the maximum length of appointment is 20 years.

Transitional provisions have been clarified and are still based on the length of time the public interest entity has used the same auditor as at 16 June 2014.

Tenure of auditor as at 16 June 2014	Transitional provision	Example, based on company with a year end of 31 December
20 years or longer	The incumbent auditor can complete the audit of the last financial period starting before 17 June 2020 but cannot be reappointed for the following year.	Year ending 31 December 2020 is permissible Year ending 31 December 2021 is not permissible
11 years or longer but less than 20 years	The incumbent auditor can complete the audit of the last financial period starting before 17 June 2023 but cannot be reappointed for the following year.	Year ending 31 December 2023 is permissible Year ending 31 December 2024 Is not permissible
Less than 11 years – audit engagement began after 16 June 2006	The incumbent auditor can complete the audit of ten financial years before a tender is required. The incumbent can participate in a tender after these ten years and could be reappointed for up to a further ten years.	Tender is required after 10 years; the incumbent auditor can participate and be reappointed for up to a further 10 years.
Less than 11 years – audit engagement began on or before 16 June 2006	The incumbent auditor can complete the audit of ten financial years before a tender is required. The incumbent can participate in a tender after these ten years and could be reappointed for up to a further ten years.	Year ending 31 December 2016 can be completed; a tender must take place for the audit of the year ending 31 December 2017; the incumbent auditor can participate and be reappointed to a maximum tenure of 20 years.

1 A public interest entity is defined in EU law as an entity with securities (debt or equity) admitted to trading on an EEA regulated market (including LSE Premium or Standard Listing, not AIM), a credit institution (bank or building society in UK terms) or insurance undertaking (including an insurance company, directive friendly society and Lloyd's syndicate. The UK is not taking option to extend the definition.

In their recent consultation, BIS has proposed that the guidance on tendering will be updated to clarify that tenders carried out before the regulation comes into force will count towards the tendering requirement as long as they met the objectives of the Regulation and followed a broadly equivalent process. This means, for example, that previous tenders will still be considered valid even if the audit committee recommended only one firm to the board for appointment (the new process will require the audit committee to recommend two firms with a clear preference for one).

Non-audit services and fees

The FRC consultation, which is still open until December, covers the following proposals:

Prohibited services – the changes are as expected

The FRC has adopted the EU "blacklist" of banned non-audit services which cannot be provided to PIEs by their auditors. Incorporated in the proposed final FRC restrictions are additional services already prohibited by current standards, reinforcing the UK's desire to be seen as having leading standards of independence but allowing Audit Committees a degree of flexibility within certain regulatory constraints.

With minor exceptions, this means that tax services are proposed to be restricted and can no longer be provided by the statutory auditor.

The "70% cap" on non-audit services – implementation proposals clarified

The EU audit regulation contains a 70% cap on non-audit fees to PIEs. To calculate the cap, you average three consecutive years of audit fees to the entity and its EEA parents and all subsidiaries (including non EEA subsidiaries) – in the fourth year, non-audit fees for services (other than those required by EU or member state law or regulation – which are uncapped) to the entity and its EEA parents and all subsidiaries (including non EEA subsidiaries) cannot exceed 70% of that average.

In practice, this means that for a company reporting at 31 December, the first calculation will be the percentage of non-audit fees in the year ending 31 December 2020, compared to the average of the audit fees for the years 2017, 2018 and 2019.

The UK's single competent authority

The FRC will be the UK's "single competent authority" with responsibility for audit regulation and oversight, with delegation to the professional bodies to the maximum extent permissible. The practical effect of this is that:

- the FRC's Audit Quality Review team will take on the inspection and monitoring of smaller unlisted insurance undertakings in addition to their current role in respect of listed companies, banks, building societies and larger insurance undertakings;
- the FRC will delegate to the inspection and monitoring of large private companies, large charities and large pension schemes, currently inspected by the AQR team; and
- increased FRC oversight of the inspections of smaller audit firms that audit only a few entities in scope for AQR review.

Summary status of audit reform implementation

Body	Status	Implementation date
EU	Regulation (EU) No 537/2014 and Directive 2014/56/EU (amending the Audit Directive) were published in the Official Journal of the European Union on 27 May 2014. Member states have until 16 June 2016 to apply the provisions.	Transitional arrangements regarding auditor rotation apply from 17 June 2014
BIS	Consulting on regulation of the audit profession, auditor tendering and rotation, and possible additional matters. Responses due 9 December 2016	17 June 2016
FRC	Consulting on responsibilities as UK competent authority. Responses due 11 December 2016	Financial years commencing on or after 17 June 2016
CMA	"The Statutory Audit Services for Large Companies Market Investigation (Mandatory Use of Competitive Tender Processes and Audit Committee Responsibilities) Order 2014" came into force on 1 January 2015	Financial years commencing on or after 1 January 2015 with transitional rules on tendering
FCA PRA	The FCA and PRA are consulting on necessary consequential amendments to their existing rules and guidance on audit committees. FCA CP 15/28 was published on 4 September and PRA CP 34/15 was published on 18 September.	Financial years commencing on or after 17 June 2016

Deloitte view

Remember that you may no longer be able to ask your statutory auditor to provide certain services – an alternative provider may be needed.

If not already completed, now is the time to draft changes to the non-audit services policy, which can be brought in from 17 June 2016. It is not expected that there will much change from this point on.

However, there remains an issue for the UK capital markets. At present, certain Reporting Accountant services (such as the long form due diligence report and the working capital review report) that are not a regulatory requirement will count towards the 70% non-audit services cap. We hope that the FCA and the FRC can find a suitable solution so as not to unfairly disadvantage smaller companies.

We hope the FRC will soften its position on tax services for private companies.

Transitional provisions in some areas will be needed.

Constructing an effective audit committee report – some focus areas

Significant issues affecting financial reporting

The audit committee should now consider reporting on significant issues affecting financial reporting as "business as usual" since companies complying with the Code will have included this disclosure for at least two years.

Any discrepancies between the significant issues discussed by the audit committee, the risks discussed in the audit report and the critical judgements and key sources of estimation uncertainty in the financial statements should be straightforward to explain. The challenge is to bring alive the recent innovations in subsequent periods, and we suggest that appropriate signposting of new items would be useful, and that recurring items should be highlighted to focus not only on the judgement but on year on year changes.

Changes of auditor

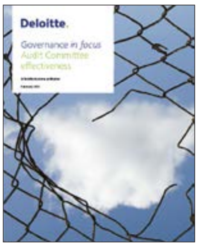
Many companies are, or will be, dealing with a change of audit firm and in relation to this there are a number of matters you could be reporting on:

- an upcoming tender;
- the current auditor is outgoing and a new auditor has been appointed for next year's report; and
- the first year of a new auditor.

There has been good disclosure on this area by some companies, but others either do not mention the change at all or do so in passing.

The table below indicates some areas of reporting that we have seen and consider good practice.

Upcoming tender	Outgoing auditor reporting; new auditor has been appointed	The first year of a new auditor
Consider including: • When the tender will be conducted • How the tender process will be conducted • Who will be invited to participate • Changes to previously announced tender timing, with reasons	Consider including: • Some details of how the tender process has been conducted and how the audit committee reached their recommendation • Details of the incoming audit firm and the audit partner • Any initial disclosures about how the incoming auditor is learning about the company (e.g. at this stage the auditor may already have met key members of management or conducted site visits) • Details of non-audit services and associated fees obtained both from the outgoing and the incoming auditor.	Consider including: • Some details of how the tender process has been conducted (if not disclosed in the previous year) and how the audit committee reached their recommendation • Details of the incoming audit firm and the audit partner • Disclosures about the transition with a special focus on audit quality



Governance *in focus*
– Audit Committee
effectiveness

Audit committee effectiveness

For the past few years, audit committees have been the recipients of ever more responsibilities and reporting requirements, including the 2014 UK Corporate Governance Code, the revised Guidance on risk management, internal control and related financial and business reporting and, most recently, the FRC consultation “Enhancing Confidence in Audit”, which includes further proposed changes to audit committees, their responsibilities for non-audit services, the Guidance on audit committees and the Code itself.

The FRC’s proposed updates to the Guidance on Audit Committees for 2016 suggests that the audit committee report should include “a summary of the review of the audit committee’s effectiveness, including how the performance evaluation has been conducted.” This requirement reflects the best practices we already see in good audit committee reports, although it is worth considering the interaction with the rest of the corporate governance statement in order to avoid unnecessary duplication.

Earlier this year, to assist audit committees in assessing their effectiveness, we issued a Governance *in focus*: Audit Committee effectiveness, available at www.deloitte.co.uk/aceffectiveness. This is a practical guide covering the key aspects of the audit committee’s remit and will be updated and republished when the new Code and updated Guidance on audit committees is issued by the FRC in the first half of next year. Audit committees could use this framework both to help assess their effectiveness and to construct their disclosure on the process undertaken.

The framework encompasses the following areas:

Governance *in focus* – audit committee effectiveness

Set up

- Establishment, membership and appointment
- The audit committee chairman
- Skills, experience and training

Responsibilities

- Oversight of business and financial reporting and other company announcements
- Culture, values, whistleblowing and fraud
- Internal control and risk management systems
- Oversight of internal audit
- Oversight of the external audit process

Making it work

- Mettings of the committee
- Resources
- Relationship with the board

Reporting

- Communication and shareholders
- Going concern and longer term viability

FRC proposed changes for audit committees in 2016

Governance *in brief* – FRC consultation: Implementation of EU Audit Regulation and Directive

FRC is consulting on changes for audit committees

Alongside the consultation on audit market developments, the FRC is consulting on detailed changes to the UK Corporate Governance Code and the Guidance on Audit Committees. As with the other elements of the consultation, responses are due in December and the changes would likely be brought in for periods beginning on or after 17 June 2016.

Proposed changes to the UK Corporate Governance Code for Audit Committees

The FRC is proposing the following changes to section C.3 (Audit Committee and Auditors) of the UK Corporate Governance Code:

- The requirement for an audit committee member to have "recent and relevant financial experience" is changed to "competence in accounting and/or auditing". More fundamentally, the audit committee as a whole will need competence relevant to the sector in which the company operates. This is likely to affect future recruitment policies.

- The FTSE 350 audit tendering provision will be removed as this is superseded by the CMA and EU requirement for mandatory tendering and rotation of the audit firm.

- The audit committee section of the annual report will need to provide advance notice of audit tendering plans. BIS is expected to provide more details in this area.

The FRC is not proposing to take forward the CMA recommendation that there should be an advisory vote on the audit committee's report, as it believes that shareholders can express views by refusing to re-elect members of the audit committee or can table a specific resolution reflecting their concerns. The FRC is, however, asking for views.

Proposed changes to the Guidance on Audit Committees

The FRC is proposing a number of changes to the Guidance on Audit Committees. In addition to changes which bring the Guidance in line with the proposed changes to the Code, there are the following proposed amendments to audit committee activities and to audit committee reporting.

Activities

Area	Guidance
Key judgements	The audit committee should consider key matters of its own initiative rather than relying solely on the work of the external auditor. It must decide whether the sources of assurance and information are sufficient and objective.
Responsibility for risk management and internal control systems – clarification	The board has ultimate responsibility for an organisation's risk management and internal control systems. The audit committee should consider what role it can play and what information it requires to assist the board in putting in place sound risk management and internal control systems.
Internal audit	This section will be updated to reflect existing good practice. The audit committee should ensure the internal auditor has direct access to the Chairman of the Board and is accountable to the audit committee. The audit committee should ensure that the internal audit plan is aligned to the key risks of the business.
External auditor	The audit committee should have primary responsibility for negotiating the fee and scope of the audit, initiating a tender process, influencing the appointment of an engagement partner and making formal recommendations to the board on the appointment, reappointment and removal of the auditors (reflecting the CMA Order). More emphasis is placed on interactions with the external auditor around the areas of significant judgement and risks to audit quality.
Non-audit services	Set and apply a formal policy specifying the types of non-audit service for which use of the external auditor is pre-approved. The guidance reaffirms that such approval should only be in place for matters that are clearly trivial.
Remuneration of audit committees	Remuneration should reflect the responsibility members bear and that a significant extra amount of time needs to be committed.

Additional disclosure proposed for audit committee reports

- A summary of the review of the audit committee's effectiveness, including how the performance evaluation has been conducted.
- The current audit partner's name and for how long the partner has held the role.
- An indication in advance of when the next tender process will be undertaken and an explanation of any changes to the intended timing of the next tender process.
- The committee's policy for approval of non-audit services (N.B. there is currently no option in the proposals for a website cross reference).
- The audit fees for the statutory audit of the company's consolidated financial statements and the fees paid to the auditor and its network firms for audit related services and other non-audit services, including the ratio of audit to non-audit work.
- For each significant engagement, or category of engagements, an explanation of the services provided and why the audit committee concluded that it was in the interests of the company to purchase them from the external auditor.
- The nature and extent of interaction (if any) with the FRC's Corporate Reporting Review team.
- When a company's audit has been reviewed by the FRC's Audit Quality Review team, disclosures about significant findings and the resulting actions they and the auditors plan to take. This disclosure should not include the audit quality category awarded.

The appendix to the current guidance on good practice in audit tendering is being removed and will be published separately drawing on tender activity to date, probably before the end of 2015.

Deloitte view

Many of the FRC's proposed changes codify existing and emerging good practice in audit committee activity and reporting, many audit committees already follow some of these practices and many aspects can be adopted early. Some of the recommended disclosures could be added to a company website rather than extending the annual report.

The clarification that the board is responsible for risk management and internal control systems as a whole is welcome. Much debate has been had on the role of the board, the audit committee and the risk committee.

As expected there is greater emphasis on the supervision of the external audit process and understanding the scope of external and internal auditors. However, there is more focus on the independent enquiry to be made by audit committees on key financial reporting judgments and their competence to make the right enquiries by understanding the company and the industry sector, and having a background as a committee in accounting and auditing. This may have some impact on future recruitment of audit committee members.

Governance hot topics for 2016

The FRC agenda for 2016 and beyond

The FRC's recently issued Strategy for 2016-2019 makes it clear that the FRC will be concentrating on promoting a step change in audit quality and on driving up standards of governance, stewardship and reporting over that period. The intention is to make the most of the changes to codes, standards and regulations introduced in recent years, while avoiding further changes and removing regulatory burdens wherever possible. The FRC will focus on the following actions over the next three years:

Implementation of the EU Audit Regulation & Directive	The FRC will work to ensure that its new responsibilities as the UK's competent authority for audit regulation are delivered effectively. The overall aim is that by the end of the strategy period at least ninety percent of FTSE 350 audits will require no more than limited improvements as assessed by the inspection programme of the Audit Quality Review Team.
Minimising compliance costs	The FRC will assess the impact of its work in each area of responsibility in order to inform priorities and help reduce the overall cost of regulation.
Greater emphasis on non-regulatory approaches	Through corporate reporting and audit quality review activities, the FRC will aim to secure continuous improvement in the quality of information and behaviour. Once the ARD changes have been implemented, there will be no further changes to the UK Corporate Governance Code until 2019. Instead the focus will be on sharing best practice and education.
Strengthening engagement with stakeholders	Building on existing initiatives such as the Financial Reporting Lab and the current initiative on corporate culture, the FRC will deepen and widen its non-regulatory approach by strengthening engagement with stakeholders, and in particular with investors. One priority will be to find ways to secure the full benefits intended from the Stewardship Code.
Holding to account	Through the work of its Conduct division, FRC will continue to hold individuals and organisations to account where this is necessary in the public interest.
Corporate culture	The project to review how boards can most effectively establish company culture and practices that embed good corporate behaviour will be completed.

Other hot topics

In order to help you fulfil your broader role as a board member, we wanted to take this opportunity to set out a number of other key themes which you may want to familiarise yourself with:

Governance *in brief* – succession planning

Succession planning

The FRC has brought out a Discussion Paper looking for evidence of good practice which can be shared more widely.

This examines the key issues, seeks to identify suggestions for good practice and considers how the nomination committee can play its role more effectively. The FRC is gathering responses until 29 January 2016, following which we can expect some insights into good succession management and high quality reporting that will be relevant to most, if not all, companies.

Women on Boards

The UK is now in sixth place in the international ranking of women on boards, with most of the countries in the top five having introduced a mandatory quota system.

This year the final report in the Davies Review series has been published. It summarises the substantial progress in the UK over the period from 2011 to 2015 – from women representing 12.5% of FTSE 100 boards in 2011 to 26.1% in Q3 2015 – and proposes a new target of 33% of women on boards for FTSE 350 companies by 2020.

The report also describes the performance of all FTSE 350 boards individually in introducing women to their boards since the start of the review.

The detail of the final proposals will be agreed early next year. The "five next step recommendations" are:

- **Voluntary approach working, albeit more to be done** – the national call for action and voluntary change should be continued for the next five years.
- **Increased target, more chairs and more action from all listed companies** – increase the voluntary target for women's representation on FTSE 350 boards to a minimum of 33% by 2020; focus on appointing more women as Chair, Senior Independent Director and as executive directors and all FTSE listed companies to assess the gender balance on their boards and act to address any shortfall.
- **Focus on the executive laye**r – extend the best practice at board level to improve the representation of women on the executive committee and other senior leadership positions.
- **Independent steering body** – this should be reconvened to support business, encourage progress and report on progress.
- **Maintaining momentum and next steps** – in consultation with key stakeholders, publish more detailed comments on the points above early in 2016.

The Modern Slavery Act 2015

For periods ending on or after 31 March 2016, companies with turnover greater than £36 million will need to publish a slavery and human trafficking statement on their website.

The only strict requirements regarding the statement are that it must:

- detail the steps taken during the financial year to ensure that slavery and human trafficking is not taking place in any of its supply chains or any part of the business (or a make a negative statement that the organisation has taken no such steps);
- be approved by the board of directors and signed by a director (or equivalent); and
- be published on the organisation's website and include a link to the slavery and human trafficking statement in a prominent place on that website's homepage (and to provide a copy of the slavery and human trafficking statement to anyone who makes a written request for one, before the end of a period of 30 days beginning with the day on which the request is received).

The Prompt Payment Code

The Department for Business, Innovation & Skills launched the Prompt Payment Code in 2012 and there are currently over 1,700 signatories to the Code.

In March this year, Code signatories were informed of a number of changes to the Code. In terms of reporting, the Code will now require signatories to report on their payment practices and policies. For large companies, this requirement will be met by complying with the new half—yearly statutory reporting requirement being introduced through the Small Business, Enterprise and Employment Bill. This will come into force in April 2016. Ahead of this, large companies are asked to report this information on a voluntary basis. All other signatories, including small and medium businesses, will be asked to report basic payment information annually on a comply-or-explain basis. This will include: the percentage of invoices paid beyond agreed terms and certain narrative information.

Disclosure of dividends – policy and practice

Investors have been calling for more transparency of a company's dividend policy and ability to pay a dividend now and in the future. This information can impact investment decisions and help assess stewardship. The FRC's Financial Reporting Lab has been working on a project, with investors and companies, looking into best practice in disclosures of dividend policy and practice by companies. Its report was issued on 24 November 2015 and explores how companies can make dividend disclosures more relevant to investors. In our annual reporting survey this year we observed that some of the companies had responded to the call:

40%

provide infomation about distributable profits

10

companies clearly set out the level of distributable reserves available to them

another **30** included some disclosure, for example highlighting certain amounts that are not distributable or discussing transactions designed to improve thecompany's level of distributable reserves

Further resources

Throughout this publication we have mentioned some of our other publications where they offer a deeper dive on the governance topics of interest, or where we believe they can add insight to your role as an audit committee member.

This section pulls together those additional resources with a brief introduction to each of them, so they are easier to refer to.

As always, do get in touch with your Deloitte partner or with us in the Deloitte governance team if you would like to discuss any areas in more detail. All governance publications are available from www.deloitte.co.uk/governancelibrary

Governance *in focus* – Audit Committee effectiveness (Published February 2015)
Audit Committee effectiveness is a checklist tool that provides a consolidated picture of the regulations governing the audit committee's work, referencing the sources of those regulations, as well as a summary of the key areas being encouraged by accompanying guidance issued by regulators. We will next update the tool once the next version of the UK Corporate Governance Code and the accompanying Guidance on Audit Committees is released in 2016.

Governance *in focus* – Risk Management: getting your house in order (Published February 2015)
Risk management: getting your house in order highlights the key challenges of the updated 2014 UK Corporate Governance Code and the related guidance, focusing on the practices of leading organisations in risk appetite, risk management and monitoring of internal controls. It poses the question: how should a company make itself ready to prepare its longer term viability statement?

Governance *in focus* – Keeping pace with tax change: a briefing for non-executives (Published January 2015)
Keeping pace with tax change: a briefing for non-executives introduces some of the systemic upcoming changes to corporate tax for large multinational companies, led by the OECD's base erosion and profit shifting initiative. Many companies are implementing changes in their approach to managing taxes and papers on tax strategy and policies are now routinely produced for board approval and to keep directors informed; there is more information in the annual report on tax; tax is being expressed as a contribution to society, part of a company's values and there is also greater internal communication so that a company's employees have the opportunity to inform themselves and absorb the company's values. We provide a summary of the debate and of the different perspectives, reflect on the implications for businesses and consider what resources businesses might use to evaluate their own positions.

Governance *in brief* – FRC calls for considered approach to succession planning (Published October 2015)
FRC calls for considered approach to succession planning provides more detail on the FRC's discussion paper, which examines the key issues, seeks to identify suggestions for good practice and considers how the nomination committee can play its role more effectively. The FRC's paper is the result of discussions with a number of interested parties and analysis of other relevant research. There is a series of questions at the end of each section, through which the FRC is keen to gather views to shape their future thinking.

Governance *in brief* – FRC publishes 2015 Corporate Reporting Review and areas of focus for the coming reporting season (Published October 2015)

FRC publishes 2015 Corporate Reporting Review and areas of focus for the coming reporting season highlights that the quality of corporate reporting continues to be a focus area for regulators, leading to boards and audit committee spending more time than ever on telling their company's story in a clear and balanced way. It explores the main findings of the Corporate Reporting Review annual report, explains the upcoming areas of challenge and the increasing focus on materiality judgements and the investor's viewpoint.

Governance *in brief* – FRC consultation: Implementation of EU Audit Regulation and Directive, CMA Order and other changes relevant to audit committees (Published October 2015)

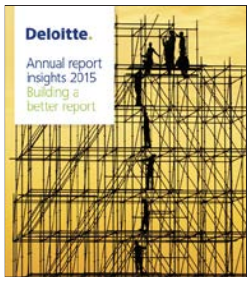
FRC consultation: Implementation of EU Audit Regulation and Directive, CMA Order and other changes relevant to audit committees explores the FRC's plans for audit committees and audit reform. It explains the changes the FRC proposes to the UK Corporate Governance Code, the Guidance on Audit Committees, the Ethical Standards for Auditors and International Standards on Auditing through its new consultation, "Enhancing Confidence in Audit".

Governance *in brief* – The longer term viability statement – a "how to" summary guide (Published October 2015)

The longer term viability statement – a "how to" summary guide explains that all companies that comply with the UK Corporate Governance Code now have to produce their first longer term viability statement, starting with September year end reporters. This guide is a timely reminder of the new requirements in the Code, bringing together emerging practice from early adopters, the key decisions boards will need to take, and a view on how auditors might engage with audit committees to address their own new requirements.

Corporate Governance Disclosure Checklist: for periods commencing on or after 1 October 2014
This is our current detailed checklist used regularly by audit committee members, company secretaries and others. It sets out the key disclosure requirements under the Listing Rules, the 2014 UK Corporate Governance Code, the 2012 Guidance on Audit Committees, the Disclosure & Transparency Rules regarding corporate governance statements and audit committees (DTR 7) and the Guidance on Risk Management, Internal Control and Related Financial and Business Reporting.

Annual report insights 2015
Deloitte has undertaken a comprehensive survey of 100 listed UK companies' annual reports, reviewing, amongst other things, disclosures on KPIs, risks, corporate governance, audit committee reporting and non-GAAP measures. *Building a better report*, is available from www.deloitte.co.uk/annualreportinsights includes our key findings and ideas on how to improve annual reports in the upcoming reporting season as well as identifying some key pitfalls to avoid. The full findings and real life examples of good practice are available in the full report, *The reporting landscape*. Every year Deloitte publishes 'Closing out' which summarises the narrative reporting and financial reporting issues that may be relevant for years ending on or after 31 December 2015 as a result of areas of focus, including those identified in the FRC's Corporate Reporting Review Annual Report 2015, the current economic environment or changes in accounting standards and legislation. This can be found at www.ukaccountingplus.co.uk



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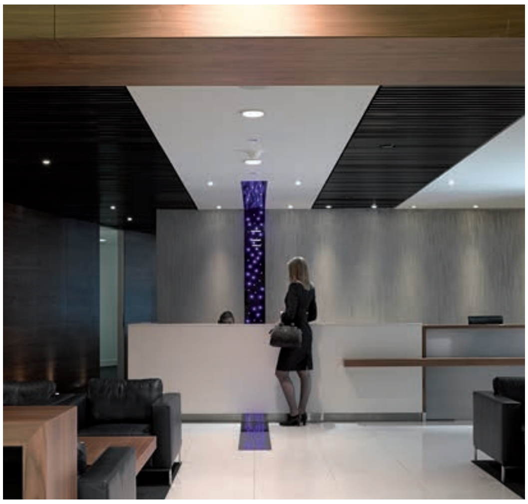
The Deloitte Academy

The Deloitte Academy provides support and guidance to boards, committees and individual directors, principally of the FTSE 350, through a series of briefings and bespoke training.

The briefings are pitched at director level and help directors keep up to date with the changing regulatory environment, address everyday business challenges as well as promote awareness of best practice and emerging issues. Sessions provide directors with the opportunity to discuss and debate matters with their peers.

Membership of the Deloitte Academy is free to directors of listed companies, and includes access to the Deloitte Academy facilities, a dedicated business centre between Covent Garden and the City. Boardrooms and meeting rooms can be reserved in advance. A lounge area and business desks are available for members to use without prior reservation. Unless otherwise indicated, all briefings are held at the Deloitte Academy facilities.



Members receive copies of our regular publications on Corporate Governance and a newsletter. There is also a dedicated members' website www.deloitteacademy.co.uk which members can use to register for briefings and access additional relevant resources.

For further details about the Deloitte Academy, including membership enquiries, please email enquiries@deloitteacademy.co.uk.

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