THE 100 GROUP

A collective voice for the development of UK-based business

THE HUNDRED GROUP
OF FINANCE DIRECTORS

Looking ahead

What you need to know Spring 2019

March 2019

The 100 Group briefing

Dear members of The 100 Group,

Welcome to the second edition of The 100 Group briefing for the financial year 2019.

Brexit continues, but significant uncertainty remains. To help you deal with the possible reporting implications of a no-deal result, we've included the recent letter from BEIS to accountants that breaks down important accounting and corporate reporting considerations for companies. We'd urge companies to keep their no-deal planning up-to-date. Other supporting materials for Brexit can be found here.

The statutory audit market reviews continue. On 11 March, BEIS launched a consultation seeking views on the recommendations made by the Independent Review of the FRC to create a new regulator responsible for audit, corporate reporting and corporate governance – Group members may wish to respond.

And with regards to the FRC, it has launched a consultation on the UK Stewardship Code, following widespread calls for the Code to focus on what high-quality stewardship entails, with the FCA also launching a consultation in January. Group members with asset management businesses or who provide other relevant services may well want to continue to engage with the FRC and FCA as the debate proceeds.

We've set out in the Executive summary the other topics included in this edition. I hope you find the briefing useful – please do let me know what you'd like to see more of in future publications.

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Looking ahead

The 100 Group briefing, *Looking ahead*, is a quarterly briefing commissioned by the 100 Group of Finance Directors. Its aim is to brief the Group on key developments in the capital markets and proposed changes in regulation and standards that might require response, lobbying, or which are important for general awareness.

For further information, please contact *Gilly Lord.*

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Key: M – Monitor R – Respond/React L – Lobby

Reporting

BEIS advice on accounting and corporate reporting if there's no Brexit deal

The Department for Business, Energy & Industrial Strategy (BEIS) has written to accountants setting out information relating to accounting and corporate reporting in preparation for a potential no-deal scenario. PwC's Peter Hogarth looks at areas covered.

The letter sets out important issues concerning the future of accounting and corporate reporting companies will need to consider for the UK leaving the EU. The contents are only immediately relevant in a no-deal scenario, but given the fact significant uncertainty remains at the time of writing, we'd urge you to follow the recommended actions so you're prepared for a no-deal scenario. The information is particularly relevant for UK and EEA listed companies, AIM companies, large privately-owned entities and Global Depository Receipt (GDR) issuers.

In October the Government published a Technical Notice covering the Accounting and Audit sector. Group members should read this, as well as related important information contained in both the *Structuring Your Business* Technical Notice, and the *Providing Services* Technical Notice. In addition, you should read the *Accounts and Reports (Amendment) (EU Exit) Regulations 2019* and the *Statutory Auditors and Third Country Auditors (Amendment) (EU Exit) Regulations 2019* and their accompanying Explanatory Memoranda. These statutory instruments remedy deficiencies in the law and mean that the UK will have a functioning legal framework on leaving the EU.

In addition, the Government has recently laid the *International Accounting Standards and European Public Limited-Liability Company (Amendment etc.) (EU Exit) Regulations 2019* that set out how new or amended IFRSs will be adopted for use in the UK after Brexit. This SI gives power to the Secretary of State to endorse and adopt new or amended IAS. A separate SI, that is expected to be made in due course, will sub-delegate the adoption function to another body (a UK endorsement body). It is expected that this UK endorsement body will take forward the work on assessing new IFRS for endorsement and adoption in the UK. It is likely to be operational during 2019, once the appropriate infrastructure and staff are in place. New or amended IFRS that are still in the process of being endorsed in the EU will be assessed for adoption in the UK by this body.

Whilst the UK's corporate reporting regime will remain largely unchanged, there are some changes that will impact a small number of companies. You should consider these, together with any transitional arrangements, to ensure that you continue to be fully compliant with the relevant accounting and reporting requirements.

Given the result of various votes that took place during March, significant uncertainty remains. In the longer term the UK will be seeking to reach agreement with the EU to obtain third country equivalence on corporate reporting to ensure the reporting requirements for companies operating across borders are recognised on both sides of the UK-EU borders. For now, we'd urge Group members to continue preparing for a no-deal scenario, paying specific attention to the areas mentioned above.

FRC consults on revised UK Stewardship Code

The FRC is consulting on a revised UK Stewardship Code, following widespread calls for the Code to focus on what high-quality stewardship entails as opposed to reporting, and for poor implementation of the Code to be highlighted and acted on. PwC's John Patterson looks at what is being proposed.

There have been a number of calls for the UK Stewardship Code ('the Code') to be tightened and more closely monitored, so that stewardship is more central to institutions' investment decisions. These have come from, amongst others, the House of Commons' Business, Energy and Industrial Strategy Committee and the Kingman Review. After an initial consultation alongside the 2018 UK Corporate Governance Code, the Financial Reporting Council ('FRC') has therefore proceeded with its plan to revise the Stewardship Code, at a time when it is proposed that a new regulator be established to replace the FRC.

Those impacted

The Stewardship Code is aimed at UK asset owners, asset managers and service providers (such as proxy advisers), and it provides a framework for them to operate within when looking after the assets of beneficiaries (such as pension scheme members and savers). The Code was previously targeted only at those investing in listed equities, but it is now proposed that the scope be broadened to cover others, including investors in fixed-income debt and infrastructure.

Although the FRC maintains the list of signatories to the Code and, in 2016, carried out an exercise to 'tier' the quality of their reporting, which resulted in a significant number being removed from the list, it has no powers to mandate organisations to apply the Code. The Financial Conduct Authority ('FCA') does, however, require most firms authorised to manage funds (excluding venture capital firms) to disclose the nature of their commitment to the Stewardship Code, or what their alternative arrangements are.

Changes to the Stewardship Code affect those caught by it directly and might have a consequential impact on corporates with whom signatories to the Code engage.

Key changes to the Code

Among the key changes proposed are:

- **Purpose, values and culture.** A new emphasis on how these matters are considered within organisations so that they fulfil their obligations to clients and beneficiaries over the relevant time horizons.

- **Environmental, social and governance ('ESG').** Explicit reference to the need to consider ESG matters when fulfilling stewardship obligations.

- **Differentiation between different links in the investment chain.** Separate recommendations and guidance for asset owners, asset managers and service providers.

- **Structure and reporting.** Structure of the Stewardship Code now more similar to the UK Corporate Governance Code, with Principles that must be applied and Provisions that are on a comply-or-explain basis. Unlike the UK Corporate Governance Code, there is also Guidance within the same document. Reporting is broken down into two parts, both of which will need to be approved by the board, submitted to the FRC and made available on the organisation's website: a Policy and Practice Statement, and an Annual Activities and Outcomes Report.

Corporate governance (cont'd)

Other changes and areas of emphasis include:

- Encouragement of adequate resourcing, so that signatories are able to fulfil their responsibilities.
- Assurance on stewardship activities becomes a Provision of the Code, so it is subject to comply-or-explain (rather than just a recommendation, as before).

Related initiatives

Alongside the consultation on the revised Stewardship Code, the FCA and the FRC have combined to issue a Discussion Paper (DP19/1), *Building a regulatory framework for effective stewardship*. The focus of this paper is more medium term than the Stewardship Code consultation. It goes back to first principles and asks questions such as what stewardship is for and why it matters, as well as what good stewardship might look like. The FCA plans to include stewardship and related issues in its research strategy for 2019/20.

The FCA has also issued a consultation paper (CP19/7) on the UK implementation of the revised EU Shareholder Rights Directive ('SRD II') – the UK must implement this Directive (2017/828) by 10 June 2019 under the terms of the draft EU Withdrawal Agreement. The proposed revised Stewardship Code generally goes beyond the requirements of SRD II, however.

The FRC consultation document envisages that the revised Stewardship Code will be issued in July 2019. Signatories would then need to submit their first Policy and Practice Statement by 31 December 2019, and the first Annual Activities and Outcomes Report within 12 months of their initial Statement. The FRC also plans more active regulation, by evaluating the quality of both pieces of reporting. Group members with asset management businesses or who provide other relevant services may well want to continue to engage with the FRC and FCA as the debate proceeds.

Investor engagement

Large investors say corporate culture and purpose are top engagement priorities in 2019

State Street Global Advisors' President and CEO Cyrus Taraporevala sent a letter to the boards of 1,120 public companies listed in the major global indexes saying that corporate culture is a top stewardship engagement priority in 2019. PwC's Hilary Eastman takes a look.

The paper accompanying the letter provides a framework for companies to evaluate the alignment of corporate culture with their long-term strategies, as well as frameworks on how boards can guide senior management on implementation.

Other key takeaways include:

- Corporate culture is critical to the long-term success of a company. When aligned with long-term strategy, corporate culture can help enable organisations to achieve their goals and differentiate them from competitors; when misaligned with long-term strategy, corporate culture can hinder performance.
- State Street believes that the board plays an important role in assessing and monitoring corporate culture, and that senior management plays an instrumental role in defining and shaping corporate culture.
- Despite the importance of corporate culture, State Street found that few directors can adequately articulate a company's culture and demonstrate how they oversee and influence change when necessary; this is partly because corporate culture, as an intangible asset, is difficult to measure.
- State Street calls on boards to proactively review and monitor corporate culture, evaluate its alignment with strategy, and incentivise management to take corrective action, if necessary.

Similarly, Blackrock's Chairman and CEO Larry Fink has sent a letter to CEOs about the link between purpose and profit, saying that their Investment Stewardship team has begun to speak to companies about corporate purpose and how it aligns with culture and corporate strategy.

In addition, other large investors are also looking at human capital. The Embankment Project for Inclusive Capitalism (EPIC) involves companies that represent $30 trillion of assets under management and almost 2 million employees right around the world. EPIC's recent research examines the human capital reporting practices of the globe's top 700 firms by revenue.

Given the growing investor interest in these areas, Group members should be prepared to discuss the management of human capital in the context of corporate culture as a driver of long-term value.

The future of audit: Update on reviews of the audit sector

There are currently a number of reviews and inquiries underway or planned into the UK audit sector. Jayne Kerr gives an update on the latest developments.

Though these reviews have a focus on audit, they have implications for everyone involved in corporate reporting and governance. Current reviews include:

- The Competition and Markets Authority (CMA) study into the statutory audit market.
- The Kingman Review of the Financial Reporting Council (FRC).
- The Brydon Review into the quality and effectiveness of audit and its future.

In addition to these reviews, a Parliamentary inquiry, led by Rachel Reeves MP, Chair of the Business, Energy and Industrial Strategy (BEIS) Select Committee, is taking place to look at the recommendations arising from the CMA and Kingman reviews with the aim of ensuring they are acted upon. Also, the Labour Party commissioned an independent review of the corporate auditing and accounting regime in the UK. The review was led by Professor Prem Sikka, who is the Professor of Accounting and Finance at the University of Sheffield. The FRC is also undertaking a post-implementation review of the 2016 changes to the Ethical and Auditing Standards to implement the Audit Regulation and Directive.

A summary of the latest developments on each review is featured below.

The CMA Market Study

On 9 October 2018 the CMA announced a study into the statutory audit market, to consider whether the market for the provision of the statutory audit is working as well as it should. The study focused on three key issues:

- **Choice and switching:** the CMA recognised that changes put in place by the Competition Commission after its review six years ago have strengthened competition between the four largest firms, but noted that there remained public concerns over choice, especially among auditors chosen by the largest listed companies.
- **Resilience:** the CMA examined whether long-term competition is threatened by the biggest firms perhaps being ‘too big to fail’.
- **Incentives:** the CMA examined concerns over whether audit committees, rather than an independent appointment body, selecting a company’s auditor might result in ‘a lack of incentive to produce challenging performance reviews’.

Assurance (cont'd)

On 18 December 2018, the CMA published the preliminary findings from its study along with a consultation on a number of proposed reforms. The CMA concluded that audit quality is falling short, for the following reasons:

- Companies choose their own auditors, and as a result there is too much evidence of picking those with whom they have the best 'cultural fit' or 'chemistry' rather than those who offer the toughest scrutiny.
- Choice is too limited, with the four largest audit firms conducting 97% of the audits of the biggest companies.
- Auditors' focus on quality appears diluted by the fact that at least 75% of the revenue of the four largest audit firms comes from other services like consulting.

The proposed remedies are as follows:

Regulatory scrutiny of audit committees, including during auditor appointment and ongoing monitoring of audit activities

This could include reporting by audit committees to the regulator before, during and after a tender selection process (with the potential for a representative from the regulator to observe the process) and reporting by audit committees on how they are monitoring the ongoing quality of the audit.

Encouraging more choice through mandatory joint audits

The CMA proposes that audits of the UK's biggest companies (FTSE 350) should be carried out by at least two firms, at least one of which would be from outside the four largest firms. They hope this will give mid-tier firms access to the largest clients, allowing them to develop their experience and credibility, while also ensuring a cross-check on quality through the joint approach.

A market share cap

The CMA recognises that a possible alternative to joint audits would be a market share cap – meaning that for a period some major audit contracts would only be available to firms other than the four largest.

A split between audit and advisory businesses

The CMA suggests that this remedy may be needed to ensure that auditors focus exclusively on audit. The immediate proposal is to achieve this via an 'operational split' of the firms into separate, economically ring-fenced businesses. Full structural split may be reconsidered if the operational split is not effective.

A number of other remedies have also been proposed:

- Reducing barriers for partners to switch between audit firms through prohibiting or limiting the length of non-compete clauses.
- Introducing a resilience remedy to protect against the negative effects of further concentration in the audit market.
- The introduction of pre-issuance peer reviews as an additional, independent quality check.

The deadline for responding to the CMA's proposals was January 21. If the CMA chooses to conduct a full market investigation, following its market study, it could take up to a further two years to complete. Group members should keep an eye out for the latest developments.

Assurance (cont'd)

The Kingman Review

In early 2018 the government launched an independent review of the Financial Reporting Council (FRC) led by Sir John Kingman. This root-and-branch review, assessing the FRC's governance, impact and powers, had the objective of ensuring the FRC was fit for the future.

On 18 December 2018, Sir John published his Kingman report. The report recommends that the FRC should be replaced with a new body, the Audit, Reporting and Governance Authority (ARGA), which would be accountable to Parliament. ARGA would have a new mandate, new clarity of mission, new leadership and new powers. Its mission would be encapsulated in an overarching strategic objective to protect the interests of investors and the wider public interest by setting high standards of corporate governance, corporate reporting and statutory audit, and by holding to account the companies and professional advisers responsible for meeting those standards.

Kingman's review also includes a number of other recommendations:

- Major steps in transparency, with individual Audit Quality Reviews and Corporate Reporting Reviews to be published.
- Significant new regulatory powers to investigate concerns relating to companies, their accounts and governance.
- A strengthened enforcement regime which would not be restricted to statutory auditors and directors who happen to be members of professional bodies.
- A fundamental overhaul of the Stewardship Code to give it greater credibility and effectiveness.
- A new market intelligence function, to identify and act on emerging risks.
- A new 'duty of alert' for auditors to report serious concerns about corporate viability to the new regulator in order to identify risks at an earlier stage.
- New intervention powers for the regulator where serious risks have been identified.

Sir John also recommends that BEIS should give serious consideration to a strengthened framework around internal controls, taking account of the operations of the Sarbanes-Oxley regime in the US. This could result in the requirement for directors of large UK companies to attest to the effectiveness of internal control and for auditors to evaluate that attestation.

Separately, Sir John was asked to look at the auditor appointment model. He recommends two changes:

- Giving the regulator, in the case of public interest entities, the right to appoint the auditor in specific circumstances (quality issues, auditor changes outside the normal rotation schedule, if there is a significant shareholder vote against the auditor appointment).
- Giving the regulator, in the case of public interest entities, the right to approve audit fees when there is a case for doing so to ensure audit quality.

BEIS published an initial consultation on 11 March asking for views on implementing many of the recommendations. Other consultations on the recommendations will follow in due course.

Assurance (cont'd)

Sir John's report is final, and on the 11 March BEIS launched an initial consultation seeking views on many of the recommendations. Group members who wish to do so have until 11 June to respond.

The Brydon Review

The government announced the Brydon Review in December 2018. Sir Donald Brydon will examine the standards being delivered by UK auditors and what further steps can be taken to make them more effective. His review will look to answer the fundamental questions of what the scope of the audit should be, who it should be for and how much assurance should be provided by auditors. In particular, it will consider:

- How far audit can and should evolve to meet investors' and stakeholders' needs.
- How auditors verify information they are signing off.
- How to manage the gap between what audit can and should deliver.
- The public's expectations about audit.

Sir Donald Brydon has stated that he will set up three groups to assist with his review, the first made up of the users of financial accounts, the second drawn from the accountancy/audit profession and the third with a specific remit to look at technology. He expects to issue an initial report to the Secretary of State by the end of 2019 at the latest, with the final report to follow soon afterwards.

We have launched our own Future of Audit initiative to canvas the views and ideas of businesses and investors, as well as get the perspectives of a much wider audience. There are no easy answers and we don't believe that a single remedy, or a single participant, can resolve the challenge. However, we hope that our initiative will provide a meaningful contribution to the debate and we will be sharing our findings with Sir Donald.

Assurance (cont'd)

FRC consulting on stronger going concern standard for auditors

The FRC has launched a consultation proposing to increase the work required of auditors when assessing whether an entity is a going concern. PwC's Jamie Shannon takes a look.

The consultation follows a number of well-publicised corporate failures where the auditor's report failed to highlight concerns about the prospects of entities which collapsed shortly after and resulting concerns about the quality and rigor of audit.

In proposed International Standard on Auditing (UK) 570 (Revised), *Going Concern*, the FRC proposes:

- Auditors make greater effort to more robustly challenge management's assessment of going concern, thoroughly test the adequacy of the supporting evidence, evaluate the risk of management bias, and make greater use of the viability statement.
- Improved transparency with a new reporting requirement for the auditor to provide a conclusion on whether management's assessment is appropriate, and to set out the work they have done in this respect.
- A stand back requirement to consider all of the evidence obtained, whether corroborative or contradictory, when the auditor draws their conclusions on going concern.

In proposing these revisions, requirements on UK auditors will be significantly stronger than those required by international standards.

The consultation period closes at 5pm on Friday 14 June 2019. Group members may wish to discuss the proposed changes and what they may mean for their company with their auditors.

IAASB launches global consultation on quality management for firms and engagements

The International Auditing and Assurance Standards Board (IAASB) is seeking comment on three interrelated standards that address quality management. PwC's Jamie Shannon looks at the scope and objective of the proposed revisions.

The proposals bring important changes to the way professional accountancy firms are expected to manage quality - for audits, reviews, and other assurance and related services engagements.

The proposed new firm-level quality management standard, *Proposed International Standard on Quality Management 1 - Quality Management for Firms that Perform Audits or Reviews of Financial Statements, or Other Assurance or Related Services Engagements*, includes a new proactive risk-based approach to designing an effective quality management system that establishes the foundation for achieving consistent engagement quality, which is in the public interest. The new approach improves the scalability of the standard because it promotes a system tailored to the nature and circumstances of the firm and its engagements. Two additional standards address quality at the audit engagement level, *Proposed International Standard on Auditing 220 - Quality Management for an Audit of Financial Statements* and the performance of engagement quality reviews *Proposed International Standard on Quality Management 2 – Engagement Quality Reviews.*

Assurance (cont'd)

The IAASB proposals are intended to improve engagement quality through:

- Modernising the standards for an evolving and increasingly complex environment, including addressing the impact of technology, networks, and use of external service providers.
- Increasing firm leadership responsibilities and accountability, and improving firm governance.
- More rigorous monitoring of quality management systems and identifying and remediating deficiencies, including root-cause analysis.
- Enhancing the engagement partner's responsibility for audit engagement leadership and audit quality.
- Addressing the robustness of engagement quality reviews, including the selection of engagements to be subject to such a review and the performance and documentation of the review.

Comments on the Exposure Drafts are requested by July 1, 2019. Group members may wish to discuss any anticipated impact of the changes to ISA 220 with their auditors. Final standards are expected in March 2020, with a likely effective date of December 2021. Further updates will be provided upon finalisation of the standards including matters for discussion with auditors.

IAASB consults on future strategy & work plan

The International Auditing and Assurance Standards Board (IAASB) is also seeking comment on its proposed strategy for 2020-2023 and work plan for 2020-2021. PwC's Jamie Shannon looks at what it is proposing.

The evolving environment in which the IAASB operates demands a strategy that reflects, among other elements, changing technology; a dynamic small and medium-sized entity landscape; and emerging reporting needs.

The IAASB is seeking comment on its proposed plan of action that it believes meets stakeholders' evolving needs and is in the public interest. It is asking for comment from global stakeholders to shape the board's strategy by commenting on its strategic themes and actions, its work plan which highlights the board's commitment to completing projects currently underway and providing views on any other topics that the Board should be considering as part of its information gathering and research activities.

Should Group members wish to respond, comments on this consultation and on the IAASB's strategic direction are requested by 4 June.

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