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 Summer 2019

June 2019

The 100 Group briefing

Dear members of The 100 Group,

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

Though regulatory changes have slowed down since this time last year, there are still a number of developments you should be aware of as we head into the summer.

Following our last edition, there have been further updates to the statutory audit market reviews. The CMA has published its final report on its market study and the BEIS Select Committee has published its report on the future of audit. BEIS has also issued a consultation on the Kingman recommendations. As with the last edition, we've included an article summarising the latest outcomes and deadlines on these so you remain up-to-date.

The IASB has also released an exposure draft on Interest Rate Benchmark reform that looks at the potential effects IBOR Reform could have on financial reporting. The exposure draft proposes that the amendments would be effective for annual periods beginning on or after 1 January 2020 and would be applied retrospectively, with early application permitted. Should Group members wish to respond, comments on the proposed changes are requested by 17 June 2019.

And finally, with Environmental, Social and Governance (ESG) matters steadily climbing the agenda over the past few years, we've included a summary of developments over the past few months.

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

IASB proposes IBOR reform amendments

The International Accounting Standards Board (IASB) has published an exposure draft on Interest Rate Benchmark reform that looks at the potential effects IBOR Reform could have on financial reporting. PwC's Peter Hogarth takes a look.

Interbank offered rates (IBORs) are interest reference rates that represent the cost of obtaining unsecured funding, in a particular combination of currency and maturity and in a particular interbank term lending market. Recent developments have brought into question the long-term viability of those benchmarks. The IASB is monitoring developments in this area in order to determine whether there are any implications for the existing accounting requirements.

On 3 May, the IASB published for public comment proposed changes to the financial instruments Standards, IFRS 9 *Financial Instruments* and IAS 39 *Financial Instruments: Recognition and Measurement* to provide relief from specific hedge accounting requirements that could result in the discontinuation of hedge accounting solely due to the uncertainty arising from interest rate benchmark reform.

IFRS Standards require companies to use forward-looking information to apply hedge accounting. While interest rate benchmark reform is ongoing, uncertainty exists about when the current interest rate benchmarks will be replaced and with what interest rate. Without the proposed amendments, this uncertainty could result in a company having to discontinue hedge accounting solely because of the reform's effect on its ability to make forward-looking assessments. This, in turn, could result in reduced usefulness of the information in the financial statements for investors.

The changes proposed include:

- Modifying specific hedge accounting requirements so that entities would apply those hedge accounting requirements assuming that the interest rate benchmark on which the hedged cash flows and cash flows from the hedging instrument are based will not be altered as a result of interest rate benchmark reform.
- Requiring specific disclosures about the extent to which the entities' hedging relationships are affected by the proposed amendments.
- Noting that the amendments would be mandatory.

The proposed amendments also note that the Board proposes to amend the hedge accounting requirements only as specified in the exposure draft and that the proposals are not intended to provide relief from any other consequences arising from interest rate benchmark reform. Moreover, the exposure draft notes that if a hedging relationship no longer meets the requirements for hedge accounting for reasons other than those specified in the exposure draft, then discontinuation of hedge accounting is still required.

The exposure draft proposes that the amendments would be effective for annual periods beginning on or after 1 January 2020 and would be applied retrospectively, with early application permitted. However, endorsement - either by the EU or the UK as applicable - could potentially lengthen the timeline before UK companies can apply the finalised amendments.

The IASB will also be separately considering a second phase of possible IBOR-related reliefs, targeted to address accounting issues that may arise when existing interest rate benchmarks are replaced.

Should Group members wish to respond, comments on the proposed changes are requested by 17 June 2019.

Investor engagement

The rise of ESG

Environmental, Social and Governance (ESG) matters have been climbing the investor agenda over the past few years. PwC's Rachel Price looks at activity over the past few months.

This has been highlighted most recently by the release of the World Economic Forum's (WEF) Global Risk publication which cited that of the top five global risks by likelihood, three related to environmental issues, and of the top five global risks by impact, four related to environmental or societal matters. This is in stark contrast to 2009 when there was just one risk - chronic disease - which was identified from an ESG perspective. Today, extreme weather events, failure of climate-change mitigation and adaptation, natural disasters and water crises are dominating the minds of the almost 1,000 decision-makers from the public sector, private sector, academia and civil society who took part in the survey. Evidently, ESG matters need to be on the agenda for everyone - from finance professionals, to asset owners to corporates.

Encouragingly, the CFA Institute annual conference, held in May in London, included a substantial number of sessions on ESG matters, aimed at raising awareness and equipping attendees with tools on how to build ESG matters into their investment decision making. The CFA Society of the UK (the UK's member organisation) is also in the process of rolling out a 'Certificate in ESG investing'. This development demonstrates both the need and appetite from investment professionals to competently build ESG issues into their considerations.

From the investor ownership perspective, the UK's Stewardship Code which was first introduced in 2010 and which is currently under review, sets the standards for investors for monitoring and engaging with the companies they own, while aiming to improve the quality of dialogue between investors and companies to help improve long-term risk-adjusted returns to shareholders. A review led by BEIS has found the Code to have not been effective in encouraging responsible long-term investment, nor consistently high standards of effective engagement between investors and company boards. It also called for greater responsibility to be placed on asset owners, with greater clarity and prominence of investment mandates, including guidance on ESG matters.

This drive towards more active management was also highlighted at the recent CFA Institute annual conference. Outlining the fact that financial analysis is no longer a differentiating factor when assessing stocks, a speaker from RBC emphasised that analysts and investors need to focus on understanding stock-specific risk factors to add value. Inevitably, there will be overlap between the stock-specific risk factors and ESG matters, which again demonstrates the importance for investment professionals in understanding and being able to assess ESG issues and their effects on companies.

Legal & General Investment Management (LGIM) take an active approach, and in their recent Ownership Report highlighted their approach to selecting investments, including how they manage climate risks, diversity, Board effectiveness and executive remuneration of the corporates they hold in their portfolios, both through active engagement and using their voting rights.

Evidencing the increasing ESG focus from a political perspective, the UK Labour party have recently said that they are investigating new plans to place climate change at the heart of their policies, and cited the possibility of delisting UK companies from the London Stock Exchange should it be deemed not to have taken adequate steps to tackle climate change.

Investor engagement (cont'd)

Investor interest in ESG matters is increasing across all sectors, and Group members should consider whether their current reporting is sufficient and how to best engage with shareholders and investors on these matters.

Assurance

Future of audit: Update on current reviews of the audit sector

As noted in our last edition, there are a number of reviews looking at the UK audit sector. Jayne Kerr summarises the latest developments.

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

- The Competition and Markets Authority (CMA) market study into the statutory audit market.
- The Kingman review of the Financial Reporting Council (FRC).
- The BEIS initial consultation on the Kingman recommendations.
- The Brydon review into the quality and effectiveness of audit.
- The BEIS Select Committee review of the future of audit.

Since the March edition of the 100 Group Briefing, the CMA has published its final report on its market study and the BEIS Select Committee has published its report on the future of audit. Also, BEIS has issued a consultation on the Kingman recommendations. The latest on each review is laid out below.

The CMA Market Study into the statutory audit market

On 18 April 2019 the CMA released their final report following their market study into the statutory audit market. In the report the CMA concludes that audit quality has fallen short, as evidenced by specific high profile failures, and by a number of audits that have been judged as deficient against regulatory standards.

The CMA has analysed the problems in the market they believe could have contributed to this perceived shortfall in audit quality, and have concluded that:

- The selection and oversight of auditors is insufficiently focused on quality.
- High concentration amongst Big Four audit firms results in limited choice and a market that isn't resilient.
- Audits are performed by firms whose main business is not in audit.

They have made a number of recommendations, which they believe will achieve the following objectives:

- Increase the effectiveness of audit committees across FTSE 350 companies.
- Increase long-term resilience and choice in the market.
- Address the problems in terms of focus on quality and choice caused by the firms' combined audit/non-audit structures.

The recommendations are as follows:

1. That there should be **robust regulatory oversight of audit committees** to make them more accountable and ensure that they prioritise audit quality. This oversight should consider audit selection processes and ongoing auditor monitoring. The recommendation includes related suggestions including:

Assurance (cont'd)

- Taking steps to promote greater investor engagement in the audit process and encouraging greater dialogue between shareholders and the Audit Committee outside the AGM.
- Auditors to present at the audited company's AGM.

2a. That **FTSE 350 companies should be jointly audited** by two audit firms, with at least one being a non-Big Four firm. The CMA proposes some limited exceptions to the joint audit requirement, with the largest and most complex companies, companies with very simple single-entity accounts and any company choosing a non-Big Four firm to be its sole auditor being exempt. However, these companies may be subject to **real-time peer reviews**, performed by a non-Big Four firm.

The CMA proposes that the introduction of joint audits should be gradual, and that companies should make the transition to joint audit no later than when their next tenders arise (rather than all companies in scope having to make the change immediately), but could do so earlier if they choose.

2b. That there should be **measures to mitigate the effects of distress or failure of a Big Four firm**. These would include regulatory monitoring of the health and resilience of the audit practices and intervention powers if necessary.

3. That the Big Four firms should be subject to an **operational split** between their audit and non-audit businesses, to ensure maximum focus on audit quality. Key elements of the proposed split include:

- No profit sharing between the audit practice and non-audit practice, with audit partner remuneration linked to the audit practice only.
- A separate CEO and Board for the audit practice, populated by a majority of independent non-executives.
- Potential introduction of a cooling-off period during which non-audit services cannot be sold to a client once an audit engagement has ended.

4. That there should be a five-year review of progress by the regulator.

This report marks the completion of the CMA's market study into the statutory audit market. The CMA does not have the power after a market study to enforce legally binding remedies. The Government will now decide which recommendations to progress. Where legislation must be passed to enact the recommendations, we expect further consultation.

The Kingman Review of the FRC and BEIS consultation on the Kingman recommendations

In 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, aims to ensure that the FRC is fit for the future.

On 18 December 2018, the Kingman Review report was published, and on 11 March 2019 BEIS issued an initial public consultation on the recommendations, categorising them into those that can be taken forward as soon as possible (Category 1), those that need further consideration, but which can be delivered in advance of legislation (Category 2), and those that will need primary legislation as they have wider ramifications, so deeper consideration and wider consultation is needed (Category 3).

The overarching recommendation, which is a Category 3, is 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.

Assurance (cont'd)

Should Group members wish to respond to the consultation, the deadline is 11 June.

Brydon Review into the quality and effectiveness of audit

The Brydon Review to examine the quality and effectiveness of the audit was launched in January, with a call for evidence issued on 10 April. Sir Donald Brydon, who is leading the review, plans to examine the existing purpose, scope and quality of statutory audit in the UK, in order to determine:

- The needs and expectations of users of financial and non-financial corporate reporting.
- How far the audit process and product may need to improve and evolve to meet the needs of users and to serve the wider public interest.
- What specific changes to the statutory audit model and wider regulatory framework for audit may be needed to deliver this, including any changes to company law.
- Whether other forms of business assurance should be developed or enhanced to enable shareholders and other stakeholders to assess better the future financial prospects and sustainability of companies.

Respondents to the review are asked to consider both the audit process and the audit product. The focus is on the statutory audit of Public Interest Entities, but will be mindful of the impact of any recommendations on smaller and non-listed entities. Chapters in the call for evidence are wide-ranging, covering, amongst other things: the definition of audit; the expectation gap; scope and purpose of audit; audit quality; directors' legal responsibilities; communication of audit findings; fraud; and auditor liability.

Sir Donald 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.

Should Group members wish to respond to the call for evidence, the deadline is 7 June.

The BEIS Select Committee report on The Future of Audit

On 2 April 2019, the BEIS Select Committee released its report on The Future of Audit. The Committee launched its inquiry into the Future of Audit on 12 November 2018 and has considered written evidence in addition to oral evidence given at a number of public meetings held by the Committee.

The report sets out a number of recommendations which the Committee believes will improve the quality and usefulness of audit, promote independence and challenge among auditors and which, in time, they believe will deliver a more competitive and resilient audit market for FTSE 350 companies.

Assurance (cont'd)

The recommendations include:

- A full structural separation of the audit and non-audit services parts of professional services firms (or at least an operational split for a trial period of three years).
- The introduction of a segmented market share cap in the FTSE 350 audit market, and the use of joint audits, on a pilot basis, for the largest and most complex FTSE 100 audits.
- The imposition of seven year terms for audit appointments, with mandatory rotation after that term.
- The introduction of a three year cooling-off period following the end of an audit engagement during which non-audit services could not be sold.

There are also a number of other recommendations covering the audit regulator, the scope of audit, the capital maintenance regime, regulatory oversight of audit committees and shareholder engagement, including:

- Greater reporting on audit fees, potentially including audit hours, staff mix and rate per hour, with increased powers of the regulator over the setting of fees.
- "Graduated" audit findings in audit reports.
- Extending the audit scope to cover the whole annual report (albeit with different levels of assurance).
- Publishing the audit report at the same time the results are announced.
- Auditors presenting at the AGM to show how they have challenged management and exercised professional scepticism.
- More vigorous enforcement of the capital maintenance regime, including definition and disclosure of distributable reserves.
- Support for the CMA recommendations of sharper oversight of audit committees.
- Further consideration of the potential independent appointment of auditors if other remedies and reforms fail.

The recommendations in the report are largely addressed to Government, and in some cases to ARGA, the CMA or Sir Donald Brydon. Government will consider the recommendations alongside those in the Kingman Review of the FRC, and those which will be made by the CMA and by Sir Donald Brydon and will consult on all recommendations it intends to take forward.