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

December 2019

The 100 Group briefing

Dear members of The 100 Group,

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

Since our last edition, PwC commissioned Professor Karthik Ramanna of the University of Oxford's Blavatnik School of Government to write an independent paper bringing a fresh perspective on what it takes for audit firms to build a culture of challenge. This edition explores some of his recommendations and how they impact our programme to enhance audit quality.

We also address a batch of recent publications from the Financial Reporting Council to draw attention to areas for potential improvement and to highlight new requirements that companies will need to grapple with for the first time this year.

And finally, amid growing political, societal and regulatory scrutiny, Mark O'Sullivan looks at some of the challenges of reporting on climate change.

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.*

Executive summary

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

Reporting

FRC identifies areas of focus for next annual reporting season

Autumn is typically peak season for year-end reporting reminders. Peter Hogarth and Mark O'Sullivan explore a batch of recent publications from the Financial Reporting Council.

October was a busy month for the FRC. It published its Annual Review of Corporate Reporting 2018/2019 and finalised three of its thematic reviews into impairment and first-time adoption of the new revenue and financial instruments standards. A further thematic review of interim disclosures in the first year of adopting the new leases standard followed in early November. And all of this was accompanied by an open letter to finance directors and audit committee chairs. This was clearly enough for the time being, so FRC decided to 'decouple' its review of corporate governance and deal with that separately.

There are some good news stories – the FRC notes better disclosure in some areas while the thematic review reports include loads of best practice examples – but the thrust of the FRC's output is to draw attention to areas for potential improvement and to highlight new requirements that companies will need to grapple with for the first time this year.

Key findings from FRC's monitoring activity

There is a high degree of familiarity in the summary of FRC's monitoring activity.

Disclosure of judgements and estimates remains the source of most questions from the FRC's Corporate Reporting Review Team, with the most frequent area of challenge being the disclosure of sensitivities or the range of possible outcomes in cases of estimation uncertainty. But it isn't all bad: fewer companies this year failed to clearly distinguish judgements from estimates; there were fewer instances of boilerplate wording; and there were fewer cases of disclosure being omitted notwithstanding evidence that a key judgement had been made or a source of significant estimation uncertainty existed.

Other areas highlighted by the FRC include:

- Cash flow statements. To FRC's eyes, errors in cash flow statements, especially misclassifications between operating, financing and investing activities, seem to be getting more common. But the FRC messaging is not just for companies to do better. It is also concerned about the transparency of disclosure of the use of supplier financing arrangements and will ask companies direct questions on whether they have entered into this type of arrangement where their usage is common in their industry. A recent report by the FRC's Financial Reporting Lab, 'Disclosures on the sources and uses of cash', contains some useful guidance and best practice examples in this area.

- Provisions and contingent liabilities. This is another area attracting an increasing number of questions, mostly concerning missing or unclear disclosure or inconsistency with information disclosed elsewhere.

- Tax. FRC gives more positive feedback on tax disclosure but remains disappointed by the over-use of 'other' to describe material amounts in tax reconciliations. Of perhaps greater concern, FRC questions the recognition of deferred tax assets in respect of unutilised losses where there is no disclosure of the nature of the evidence supporting the recognition of the asset.

- While not amongst the top ten chart of issues frequently raised, FRC considers that its most complex cases have often related to control or joint control of another entity. And once again, the very nature of the judgement that needs to be made – whether to consolidate – means that it often has a material effect, so FRC would expect disclosure of how the board has made that judgement.

Reporting (cont'd)

Narrative reporting

Some of the key narrative reporting themes are consistent with prior years.

- Disclosure of principal risks and uncertainties. More companies were written to in this period with enquires prompted by information set out elsewhere in the annual report or externally that might give rise to significant risk but which weren't identified as such. Particular attention was made to the area of climate risk. In July, the FRC published a statement setting out what it expects companies to report on in relation to climate risk, namely how the board has taken account of the resilience of the company's business model and its risks, uncertainties and viability in the immediate and longer term. It should also consider the impact on the financial statements, including in relation to asset valuation, assumptions used in impairment testing, depreciation rates, decommissioning liabilities and financial risk disclosures.
- The comprehensiveness of business reviews. There is sometimes limited reporting about significant balances or transactions that occur in a year and the impact these have on performance, working capital and cash flows.
- Adjusted performance measures (APMs). Improvements have been noted in the year with better labelling, less prominence given to such measures and more informative reasons given as to why they have been used. However, this will continue to be an area of focus with FRC looking for clear use of definitions and / or reconciliations to the equivalent IFRS line item, and less identification of 'non-recurring' items that have been evident for a number of years.

The FRC has also reminded companies of the various new requirements that will apply this year, including the s172(1) statement and reporting on engagement with employees, suppliers and customers that were described in our previous Briefing.

Thematic reviews

The thematic reviews of the new revenue and financial instruments standards (IFRSs 15 and 9 respectively) follow the FRC's preliminary review of interim disclosures published last year. Notwithstanding the significant challenge that adopting these standards presented for some companies, FRC believes that, broadly, companies dealt well with the implementation. Nevertheless, it has identified some scope for improvement, especially in the explanation of accounting policies and, unsurprisingly, disclosure of judgements and estimates.

There is an opportunity to learn from the experience of adopting IFRSs 15 and 9 as the new leases standard (IFRS 16) is implemented this year. Clear explanations of accounting policies (including the approach to transition and any exemptions and practical expedients used) and disclosure of judgements and estimates (such as lease term and discount rate) will likely be high on the FRC's list of questions to ask. The thematic review on IFRS 16 highlighted these areas, and also emphasised the importance, for the vast majority of companies that follow the modified retrospective basis of adoption (that is, without any change to comparatives), of explaining the difference between last year's operating lease commitment and this year's opening lease liability, as well as the impact on comparability of any APMs.

Reporting (cont'd)

The thematic review of impairment wasn't prompted by any change to accounting standards but instead reflects the current economic uncertainty and some degree of investor concern. FRC's view from the sample of companies reviewed is that most did some things well, but no company was perfect. Again, in FRC's view, most companies could improve their disclosure of estimation uncertainty, especially in identifying what were the key assumptions, not just the discount and long-term growth rates, and the sensitivity of the outcome to changes in those assumptions.

As well as carrying out the thematic review, FRC has also devoted some attention to the carrying value of investments in parent company accounts where that exceeds the market capitalisation of the group (prima facie, an indicator of impairment). This is far from an esoteric point, as any write downs in the parent's own accounts might reduce the amount of profits available for distribution. Accordingly, in such circumstances, FRC expects companies to disclose how the matter has been considered.

Group members should read the FRC's open letter to finance directors and audit committee chairs and go deeper into FRC's other reports where a matter is of particular relevance.

Reporting (cont'd)

The challenges of climate change reporting

Amid growing political, societal and regulatory scrutiny, Mark O'Sullivan looks at some of the challenges of reporting on climate change. With the TCFD framework emerging as the one to follow, what does this mean for UK annual reports?

Climate change under the spotlight

In recent months there have been two very significant announcements in relation to UK climate change reporting.

In July 2019 the Government announced, as part of its Green Finance Strategy, the expectation that listed companies and large asset owners should report in line with the recommendations of the Task Force on Climate-related Financial Disclosures ('TCFD') by 2022. Then, in October the FCA announced, in response to its 2018 discussion paper on Climate Change and Green Finance, that it would consult early in 2020 on making TCFD disclosures mandatory for certain issuers.

It's therefore clear that the TCFD framework is well on the way to becoming the standard model.

This was further emphasised in the latest report from the FRC Reporting Lab, 'Climate-related corporate reporting - Where to next?', published in October. This is structured around the TCFD framework of governance, strategy, risk management and metrics and targets, on the basis that the discussions with participants in the Lab's project coalesced around it. Group members will find that the Lab report includes a range of examples of developing reporting practice, as well as an outline of what investors want to understand and suggestions for some key questions companies might want to ask themselves.

Climate change in the annual report

The TCFD framework is clear that the reporting it drives should be in the 'annual financial report'. In the past, much reporting on environmental matters, including climate change where it has been discussed, has been in separate sustainability reports (and it's notable that many of the Lab's reporting examples are not from companies' annual reports). The TCFD's stipulation about being in the annual report is clearly aimed at giving the area a higher profile - and, crucially, at having companies set out the potential financial impact of climate change on their businesses.

This in itself creates a challenge. The disclosures that the TCFD requires are likely to be quite extensive in some cases (if done well), so that the level of detail given on this one topic can often be very different from other aspects of the annual report. The TCFD disclosures are currently usually given together too, so that there can be a risk of a climate change 'silo' being established within the annual report.

Then there is the question of how the TCFD disclosures fit with other existing UK reporting requirements.

Where it is seen as a strategically material issue, climate change should potentially figure within the strategic report as part of principal risks and uncertainties, the non-financial information statement and, going forward, the new statement on how directors have had regard to their duties under s172 of the Companies Act.

Under the 2018 UK Corporate Governance Code, climate change could also be relevant to an assessment of emerging risks, and the longer term assessment of a company's prospects that the FRC is calling for as part of the viability statement, as well as to the discussion around the sustainability of the business model that the first Provision of the revised Code calls for.

Reporting (cont'd)

The FRC drew companies' attention to these issues in its annual review of corporate reporting and open letter to finance directors and audit committee chairs issued in October, and it will clearly be monitoring how companies incorporate climate change into their narrative reporting in the upcoming reporting season.

The FRC also reminded companies that it's not just a 'front half' issue - it can also impact on the financial statements, in particular in relation to asset valuation and impairment testing assumptions. This point was further emphasised in their Thematic Review on impairment, also published in October, where the FRC observed that only one company within the scope of the review sample had made an overt reference to the implications of adapting to climate change in its impairment testing, whereas several had identified it as a principal risk or an issue affecting the business model in the longer-term.

While there is not yet any specific requirement in the UK to report on climate change, it's clear that companies are in practice already expected to do so, where material. The challenges of reconciling TCFD with existing reporting requirements are already there, even with the limited version of the framework that most of those adopting it early currently present. More guidance is likely to be needed on how to integrate it (where appropriate) if companies are required to reflect the full TCFD framework in the annual report and avoid duplication and clutter.

Whilst there is currently no specific requirement to report on climate change, Group members should prepare themselves for a time when it is mandatory. In particular, Group members should familiarise themselves with the FRC's Reporting Lab paper on Climate-related Corporate Reporting and consider what information their company is providing on its impact on the environment, principal risks, how the board has considered the long-term success of the company and, where material, the impacts on the financial statements.

Audit and Assurance

The future of audit: Current reviews of the audit sector

The UK audit sector has been subject to a number of recent reviews and some remain ongoing. The reviews that are complete, such as the CMA Market Study into the Statutory Audit Market and the Kingman review of the FRC, have resulted in many detailed recommendations for Government to consider. The BEIS Select Committee has also made recommendations to Government following its inquiry into the future of audit where it considered written evidence in addition to oral evidence given at a number of public meetings. BEIS now has a critical role in examining all of the recommendations and determining which will work best together to drive positive change.

The CMA Market Study into the Statutory Audit Market and the BEIS consultation on the CMA recommendations

On 18 April, 2019 the CMA released its final report following its market study into the statutory audit market. In the report, the CMA concludes that it believes 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 it thinks could have contributed to this perceived shortfall in audit quality, and has 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.

It has made a number of recommendations, which 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.

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.

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

Group members may wish to familiarise themselves with the detail behind the CMA recommendations, which can be found here.

Audit and Assurance (cont'd)

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

In 2018 the Government launched an independent review of the 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 this year 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. The full list of recommendations, and their categories, can be found in the full review here.

The BEIS consultation closed in June 2019 and we expect further consultation as part of a Government white paper on all the reviews in the first quarter of 2020.

The Brydon Review into the Quality and Effectiveness of Audit

The Brydon Review was launched in January, with a call for evidence issued on 10 April. Sir Donald Brydon, 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 were 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 expects to issue an initial report to the Secretary of State by the end of 2019 with the a public report to follow in the week commencing 13 January 2020. Like the CMA and Kingman recommendations, it is expected that Sir Donald's recommendations will be consulted on as part of the Governments white paper in the first quarter of 2020.

Audit and Assurance (cont'd)

Building a culture of challenge in audit firms - An independent perspective

PwC commissioned Professor Karthik Ramanna of the University of Oxford's Blavatnik School of Government to write an independent paper bringing a fresh perspective on what it takes for audit firms to build a culture of challenge. PwC's Chris Mansell summarises what Professor Ramanna found.

Professor Ramanna's recommendations, published in his recent paper, encompass how auditors are trained and mentored throughout their careers by those more senior, how shared beliefs are created and conveyed, how a firm's organisation is aligned to reinforce cultural values, and how audit firms can make robust processes and controls more visible to external stakeholders.

Professor Ramanna points out that audit firms alone cannot achieve a culture of challenge, highlighting the need for audit committee chairs to work together with auditors to reinforce the value of external challenge that auditors bring.

Responsibilities of companies

Professor Ramanna suggests that despite their best aspirations, a company's management cannot be expected to sustain its auditor's challenge in equilibrium; rather, a company's non-executive directors may be better placed to drive the demand for challenge from the company's external auditor. He recommends that non-executive directors could consider empowering rank-and-file auditors to challenge company management as needed by:

- ensuring the audit engagement team are able to have year-round conversations with others in the company, beyond the finance functions; and
- considering meeting with the whole audit engagement team before they begin their annual process, explicitly offering 'air cover' and the licence to probe.

Responding to the recommendations

PwC is now actively considering Professor Ramanna's recommendations and assessing how they might interact with our previously announced programme to enhance audit quality. But this is a profession-wide issue and we hope that his independent perspective will also prove useful to the profession as a whole as we work to rebuild trust in audit.

Group members should think about how they can work with their non-executive colleagues to consider Professor Ramanna's recommendations in their organisations. Please do send any feedback you have on the recommendations or your own views on how to ensure a culture of challenge in audit firms to: futureofaudit@pwc.com.

Governance

FRC issues revised Stewardship Code (2020)

The Financial Reporting Council ('FRC') has issued a revised version of its Stewardship Code (the 'Code') for asset owners, asset managers and service providers such as proxy advisers. The Code is important for companies because it sets expectations for how the investment industry should relate to and engage with them. There is now a greater focus on reporting on the activities of signatories to the Code and the outcomes they achieve, rather than simply on their policies. This could result in an increased level of engagement and challenge for management and directors of investee companies.

The Code has been under particular scrutiny because one of the recommendations of the Kingman review was that it should be abolished if it was not successfully reformed. The revised Code is also the first major publication under the FRC's new Chair and CEO team which, in this context, is likely to add to its profile. Organisations must submit their first report under the 2020 Code by 31 March 2021 to be included in the initial list of signatories, which will be published in the summer of 2021.

Structure and content of the Code

The revised Code consists of 12 Principles for asset owners and asset managers and, separately, six Principles for service providers. Reports must be reviewed and approved by the governing body, and signed by the chair, chief executive or chief investment officer

The FRC had originally proposed to have Principles (to be reported against on an 'apply and explain' basis), Provisions (on a comply-or-explain basis) and Guidance – mirroring the shape of the UK Corporate Governance Code. However, during their consultation process, they received feedback "that there were too many Principles and Provisions, and that the Code would benefit from a simpler structure". So, despite strong support for the originally proposed structure, the final version of the Code does not include Provisions or a Guidance section. Instead, under each Principle there is a set of Reporting expectations, divided into Context, Activities and Outcomes subsections.

Consistent with this, and emphasising the move away from descriptions of policy and process, the FRC's original proposal to split reporting against the Code into two elements (a standing Policy and Practice Statement and an annual Activities and Outcomes Report) has also been changed so that there will now only be one annual Stewardship report reflecting the Reporting expectations and the organisation's activities and outcomes over the past 12 months.

The content of the revised Stewardship report largely reflects the proposals in the consultation document, and there is now a specific requirement for the reporting to be fair, balanced and understandable. It should also include how signatories have:

- taken environmental, social and governance factors, including climate change, into account;
- exercised stewardship across asset classes beyond listed equity, such as fixed income, private equity and infrastructure, including investments outside the UK;
- reflected the organisation's purpose, investment beliefs, strategy and culture in the year. They are also expected to show how they are demonstrating this through appropriate governance, resourcing and staff incentives.

Group members may wish to familiarise themselves with the Code and the Feedback Statement on the consultation process, which are available here. The FCA has also been active in this area and published a substantial feedback statement (FS 19/7) on the same day as the FRC issued the revised Stewardship Code. It is also available at the link above. The FCA does not propose to impose further regulation on the asset management and life insurance sectors at the present time, but will continue its work in this area.

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