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Looking ahead: What you need to know Summer 2018

The 100 Group briefing

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The 100 Group briefing

Dear members of The 100 Group,

Welcome to the third edition of The 100 Group Briefing for 2018. As we head towards the summer there are a number of developments in reporting, governance, assurance and investor engagement you may wish to review.

In reporting, companies with December year ends will soon publish their first interims under the new Revenue and Financial instruments standards. We've highlighted some things to consider prior to the upcoming interim reporting season - detailed consideration will be necessary to get the first IFRS 15 and IFRS 9 compliant figures correct and to clearly present the impact of the transition to those standards.

The other major topic in this edition is the government announcing an independent review of the FRC. The purpose of the review is to assess the FRC's governance, impact and powers to help ensure it is fit for the future, and will be completed by the end of 2018. Group members are advised to monitor developments – just last week the FRC sent out a Call for Evidence, and we'd encourage you to consider responding.

There are also a number of initiatives associated with the governance reform agenda that are due to be finalised over the summer. It's a significant set of changes, individually and in combination so we've included a summary of what to look out for over the coming months.

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 and how we can improve the publication.

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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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Reporting

New Revenue and Financial instruments standards are now live

The beginning of this year was an important watershed for IFRS reporters. Companies with December year ends are now using the new standards for revenue recognition (IFRS 15) and financial instruments (IFRS 9). They will soon publish their first interims under those standards, showing at last what the real impact is. PwC's Peter Hogarth highlights some things to consider prior to the upcoming interim reporting season.

PwC have looked at a sample of 73 listed companies that were amongst the first to produce December 2017 annual reports, specifically to see what they said the expected impact of the new standards might be.

The headline is that only a small minority of those companies we looked at are expecting a material impact. This came as something of a surprise, and we would encourage Boards to consider carefully whether all key areas are covered before publishing the first set of numbers under the new standards.

Those companies disclosing a material impact from IFRS 15 operate primarily in industries where long-term contracts are prevalent. This is a high-profile area of accounting currently, and the different approach taken by IFRS 15 needs to be worked through carefully.

For companies with any impact from adopting IFRS 15, material or not, two further questions must be considered:

1. Taxes: Is there a cash tax impact from the changes? Or any deferred tax to account for if accounting recognition is now different from tax recognition? Very few companies provided detail on the tax impact in their December 2017 disclosures, implying that these questions are still to be answered.

2. IFRS 15 allows different approaches to transition, but 68% of companies did not state which approach they would use, implying that this is not yet decided. The decision is important, and should be made quickly, as it impacts how the transition is presented and what information is required to be disclosed in 2018 interims.

As regards IFRS 9, the vast majority of companies stated that this new standard would have no material impact. Interestingly, whilst applying IFRS 15 can produce the same accounting outcome as the previous standard after following a different thought process, this is not the case with IFRS 9 and its predecessor.

There are two areas relevant to the majority of companies outside the financial services sector where this is the case; the impairment of financial assets (i.e. receivables) under the "expected credit loss" model and the accounting for modification of financial liabilities (i.e. borrowings). If you have financial assets on balance sheet or any borrowings that have previously been modified at any point

during their lives, there is an adjustment to make upon IFRS 9 transition; the only question is how material that adjustment is. 46 companies mentioned the expected credit loss model, saying the impact was immaterial, and of those 8 gave figures showing they had done some calculation to justify this conclusion. Other companies disclosed no figures, raising the question as to how they were comfortable that the adjustment is not material. None of the companies surveyed mentioned debt modification at all, which leaves it unclear as to whether this has even been considered.

Finally, our survey identified what could be a missed opportunity. IFRS 9 permits hedge accounting in more scenarios than its predecessor. This was supposed to be a useful relaxation to companies to permit greater alignment of common hedging strategies and the accounting rules, yet none of the companies surveyed noted that they had considered this. The good news is that companies can pick this up at any point by putting hedge documentation in place and starting to hedge account for different transactions – the opportunity is not lost, just not picked up as quickly as it could have been.

The experience of IFRSs 9 and 15 might be helpful as Boards turn their attention to IFRS 16 on leases, which becomes effective next year. In this case, it is more likely that the new standard will have a material impact on almost all companies. So a greater level of disclosure of the expected impact would seem to be required in this year's annual reports. Of the companies we surveyed, 8 already have some form of quantification of the future impact published.

Detailed consideration will be necessary to get the first IFRS 15 and IFRS 9 compliant figures correct and to clearly present the impact of the transition to those standards. The transition to IFRS 16 is still a year away but will be a significant exercise for many companies and so should be high on the watch list for Group members.

Responding to the new Non-Financial Reporting Regulations

Our Corporate Reporting team has looked at the response to this new reporting requirement – and found there's more for companies to do in year two. PwC's Richard Haig provides the key findings below.

The themes of accountability and the need for boards and companies to focus more on stakeholder impact have been uppermost in the government's governance reform agenda.

The new Non-Financial Reporting Regulations ('NFRR') had the potential to be an opportunity for companies to provide more meaningful and insightful disclosures on how they relate to their stakeholders.

But from our early conversations with companies it seems that the NFRR had, to an extent, passed under the radar and awareness came late for many.

For quoted companies, already subject to the narrative reporting regulations that cover much of the same ground, the new regulations were often deemed to have already been addressed. There was also much discussion around what the differences in regulations might mean and what others would do in year one. Few felt that the time was right to put great focus on the new requirements. The very fact that there's a wider debate underway in the UK around stakeholders and long-term sustainability

meant that the new regulations were arguably ahead of their time, making it difficult for companies to respond whilst taking account of all the moving parts.

Against this backdrop we reviewed a sample of the first batch of reporters caught by the new regulations to see how they'd responded. What we found was a mixed picture – leading us to believe that the new regulations have not so much been an opportunity missed as an opportunity turned down, at least in this first year.

Overall, it was often unclear whether a company had, or had not, responded to the new requirements – only 30% of companies made any reference to the regulations and there were minimal changes in what companies reported. The well-established areas of the regulation – such as environmental and employee reporting – continued to be reported with some minor changes to reflect the language of the regulation e.g. use of phrases such as 'policies' and 'impact'. We also noted references to some of the newer themes such as anti-corruption/bribery and human rights but these tended to be from companies already reporting on these areas.

However, it was in the new areas of 'policies', 'impact' and 'due diligence', where we saw the fewest changes. There were references to 'policies', or some such similar phrase, but they rarely explained the objective of the policy, its strategic relevance, or how the outcome of the policies might be measured. References to any due diligence over the policies in question were almost non-existent.

We did see a growing use of the term 'impact' or 'outcome' in support of the requirement for companies to report on the impact of their activities. But in truth much of the disclosures still focused on companies' own activities and operations rather than on the impact they have on others. In fairness, this is not surprising as the shift from measuring inputs to valuing and quantifying outcomes/impacts is still nascent and it's clear from our conversations with companies that more guidance is required on what is meant by 'impact' and how it might be quantified.

Our strong view is that these new regulations will continue to increase in significance as the rest of the stakeholder agenda drops into place. Their importance and broader significance should not be understated and we believe that many companies will need to look again at the regulations.

This new area of reporting will require a shift in the mindset of companies if it is to be done well. However, we believe there are some simple steps companies can take which we set out in our paper.

Supplier financing

Supplier financing, also referred to as 'reverse factoring', refers to arrangements in which a bank facilitates payments between a buyer and a supplier such that the supplier can be paid earlier (or the buyer can pay later) than the original due date. Such arrangements have been around for some time, however, there is currently increased focus on this area due to the recent collapse of Carillion and the related discussion around its use of supplier financing. PwC's Frances Coldham looks at what Group members may wish to think about.

The Parliamentary Select Committee report into Carillion referred to Carillion's supplier arrangements as '*unusual in both the harshness of the alternative standard payment terms and the extent to which the company relied on it*', and also noted that

'*Carillion explicitly used its EPF [Early Payment Facility Option] to avoid "damaging our working capital" and because it was vulnerable to its own customers not paying within 45 days. This only serves to highlight the fragility of Carillion's business model.*'

In January the FRC reminded Boards of companies in the construction and business support services sectors of their reporting obligations, in particular noting *'clear information on the levels of debt, cash flows and the conversion (including processes of conversion, such as invoice discounting and reverse factoring) of operating profits into cash is also important*', and drew attention to the new IAS 7 disclosure requirements on finance obligations noting that '*The new requirements provide an opportunity for companies to improve the clarity of their disclosures, particularly in those areas where investors have voiced disappointment; for example, on the disclosure of financing facilities such as invoice discounting and reverse factoring arrangements*.'

This has been followed by a further reminder from the FRC in its recent Corporate Reporting Review Briefing confirming that '*The transparency of supplier finance arrangements will be an area of specific FRC focus during 2018*'. The briefing refers to the concern of stakeholders around the accounting and transparency of disclosure of such arrangements. In particular it draws attention to IFRS 7's requirements for disclosure of the 'nature and risks around financial instruments, including liquidity risk', as well as the requirements for the strategic report and disclosure of significant judgements, concluding: '*We would expect these requirements to lead companies to disclose the nature of any material supplier financing arrangements, the implications for the company's liquidity and the relevant amounts. We would also expect any significant accounting judgements to be disclosed.*'

The key accounting question from the reporting perspective of the customer is whether trade payables have been extinguished and replaced with a bank debt. This might seem like semantics, but it is an important distinction as presentation as financing as opposed to trade payables will impact borrowing capacity, working capital disclosures, covenant ratios, net debt disclosures and cash flow statements, and potentially credit ratings.

Clearly there is judgement involved in the presentation decision; each set of facts and circumstances will be different and therefore will need to be assessed individually, however, some of the key indicators that trade payables have been replaced by bank debt are set out below:

- The purpose of the arrangement is to improve the buyer's working capital position, i.e. rather than to assist the supplier's in obtaining credit;
- There is a change in payment terms as a result of entering the scheme, in particular where the buyer pays the bank later than the original invoice date, or the revised terms of payment are outside normal industry terms;
- The buyer receives fees or makes payments to the bank other than payment of the original invoice under its terms, such as receiving an early payment discount despite themselves not actually paying early;
- A group entity enters into an agreement to guarantee a subsidiary's payables in conjunction with the supplier finance;
- The timing of the cashflows of the buyer are impacted significantly by the arrangement as compared to similar invoices that are not part of the scheme;
- The buyer does not have the option to determine when to settle the liability.

The above is not an exhaustive list and care to understand the specific facts and circumstances is required. Also, some indicators may be more relevant than others in any given scenario and therefore judgement is required at arriving at the most appropriate accounting treatment for the specific arrangement. However, whether the conclusion of the above considerations is to derecognise trade payables or not, and perhaps more so where it is to not derecognise, it is important that heed is taken of the FRC's reminder to ensure clear and transparent disclosure of such arrangements is provided for users of the accounts, including where relevant, disclosure of a critical accounting judgement.

Corporate governance

Update on corporate governance reform

PwC's John Patterson has an update on corporate governance and reporting changes to look out for over the coming months.

A number of initiatives associated with the governance reform agenda are due to be finalised over the summer.

First to arrive, by mid-June, is expected to be a statutory instrument introducing new reporting regulations into the Companies Act 2006 on how boards have carried out their duties as directors under section 172 of the Act, including engaging with employees and other stakeholders. It is expected that reporting regulations introducing governance reporting for certain large private companies will be published at the same time. Both of these sets of regulations are likely to affect subsidiaries as well as groups (making the private company governance piece relevant for the 100 Group), and to apply for periods beginning on or after 1 January 2019.

A group including the Institute of Directors, Confederation of British Industry, Institute for Family Business, ICSA: The Governance Institute and others, with the FRC as secretary and James Wates as chairman, is working on a set of governance principles for private companies to use under the new reporting regulations and is expected to consult formally on them soon.

The FRC continues to work on its revised UK Corporate Governance Code, following the record number of responses received to its consultation last winter. It's possible that the new Code will be issued in July and it is still expected to apply for periods beginning on or after 1 January 2019. Indications are that the final version will not differ radically from the consultation document – it will certainly put more emphasis on stakeholders, consistent with the new section 172 reporting regulations discussed above.

Also closely connected to the governance reform agenda, BEIS issued a formal (though relatively high-level) consultation in March 2018 on Insolvency and corporate governance, ahead of the Business Secretary Greg Clark's appearance before the House of Commons Select Committee which is looking into the collapse of Carillion. There was also a more extensive earlier consultation on options for revising the insolvency framework in March 2016, which has not yet been acted upon.

The new consultation looks at how directors can be held to account better when businesses in trouble are sold off or managed to the detriment of stakeholders, including employees. It also asks whether improvements in corporate governance and stewardship are required to address such circumstances, as well as suggesting that changes might be needed to the basis for dividend payments. The consultation closed on 11 June 2018.

This is a significant set of changes, individually and in combination, all connected back to the government's governance reform agenda and now given additional energy by the Carillion issues. Some commentators believe that the way the BEIS consultation on Insolvency and corporate governance proposes applying hindsight tests to board decisions would discourage good candidates from wanting to be company directors, so Group members may wish to consider making their views on that known in particular.

Investor engagement

Communicating with investors about new accounting standards

With many new accounting standards becoming effective over the next few years, investors and analysts will be looking to understand how the changes will affect the companies they're invested in or following. PwC's Hilary Eastman looks at how companies can communicate these changes effectively.

As a minimum, companies need to meet their disclosure requirements for the upcoming changes as they adopt a new accounting standard. Also, the Financial Reporting Council has said that they expect to see detailed quantitative disclosure in the last set of financial statements before implementation.

But of course these are just minimum requirements. We would encourage companies to go beyond the minimum and to provide information that investors and analysts will really find useful. Investor relations teams and the questions being raised on analyst calls will be a good gauge of what that will be.

While some investors may not have been asking about the impact of the new standards (yet), they will be interested in knowing the difference between their estimates of the change and your actual calculations. The detail and rationale behind these calculations will be crucial for their analyses. Ultimately, they are trying to assess the economic impact vs. the accounting impact.

The market does not like uncertainty and will try to fill in any gaps in information. In our recent investor survey on corporate reporting, investors and analysts said the top source of information about the changes is a company's annual or quarterly reports. High on the list as well are educational events or presentations organised by the company. But they also look to investor organisations and the media, so it is important to ensure that you are the one providing the messages about the effect on your company, not letting the market guess.

What information are they looking for? Our discussions with investors and analysts highlight some common themes:

- Describe how the change affects your company specifically, and avoid boilerplate descriptions of the new accounting policy
- Clearly explain and reconcile differences between the previous accounting standard and the new one
- Provide clarity on assumptions used to arrive at the new balance sheet and profit or loss amounts
- Avoid including additional non-GAAP financial measures, which will reduce comparability and lead to uncertainty about the results.

As well as being interested in how the numbers are changing, analysts' views of your company are influenced by how you react to and implement a new standard. They often worry that companies use opportunities like this to hide bad news affecting the business – so Group members should think about whether they are being sufficiently transparent and proactive in communicating this change.

Assurance

Government announces review of FRC's role and powers

In mid-April the government announced a review of the Financial Reporting Council (FRC). PwC's Deborah Karmel looks at what it will include.

The government has launched an independent review of the FRC which is to be led by Sir John Kingman, Chairman of Legal & General plc, and completed by the end of 2018. An advisory board has been announced which will be responsible for challenging and scrutinising the review's findings and recommendations and advising on the direction of the review.

The purpose of the review is to assess the FRC's governance, impact and powers to help ensure that it is fit for the future. The aim is to make the FRC "*the best in class for corporate governance and transparency"*, whilst helping it to fulfil its role of safeguarding the UK's leading business environment. The published terms of reference for the review include the FRC's governance and transparency, avoidance of conflicts of interest, the FRC's independence, oversight and accountability and its impact, resources and capacity. There will be a public consultation with the aim of encouraging views to be submitted on the FRC's role in the British economy. A further consultation will be held on the government's proposed response to recommendations which are made following completion of the review.

The review comes at a time when the FRC, now a public body, is coming under increased scrutiny from MPs, in particular from the joint Work & Pensions Committee and BEIS Committee in their inquiry into the collapse of Carillion Plc. The joint Committee's report which was published in May 2018 criticised the FRC as too "*passive, timid and toothless*". Most recently, the Chairs of the joint Committees (Frank Field MP and Rachel Reeves MP) wrote to the FRC asking for details of progress in the FRC's investigations launched following the collapse of Carillion Plc and inviting comments on the findings relating to the FRC in the MPs' report. The Chairs also wrote to Sir John Kingman asking that he confirm that his review will consider whether the FRC's leadership is equipped to bring about the cultural change which the MPs believe is needed there. This is clearly a time of change for the FRC and it will be interesting to follow the progress of the review, to contribute to the consultation and to anticipate how the FRC will change to ensure it is fit for the future.

There will be a Special Report from the joint Committees which is to be published in late July and will include responses to the series of letters sent in May 2018 to interested parties. Group members are advised to monitor developments – just last week the FRC sent out a Call for Evidence, and we'd encourage you to consider responding. Those who wish to do so have until 6 August 2018.

IESBA consults on Professional Skepticism

In mid-May the International Ethics Standards Board for Accountants (IESBA) released its consultation paper on Professional Skepticism. PwC's Diana Hillier looks at what's included.

Over the past few years, there have been a number of calls for the IFAC standard setting boards to enhance the way in which their standards address professional scepticism. For example, in response to the International Auditing and Assurance Standards Board's (IAASB's) December 2015 Invitation to Comment, *Enhancing Audit Quality in the Public Interest: A Focus on Professional Skepticism, Quality Control and Group Audits*, many commentators called for a more consistent exercise of appropriate professional scepticism by professional accountants in the context of audit and other assurance engagements. Others - including IFIAR, the PCAOB, and the IFAC Professional Accountants in Business Committee - pointed out that it is a concept that applies to all professional accountants, and, therefore, called on IESBA to include more about it in the IESBA Code of Ethics.

IESBA's consultation paper seeks to gain input on the IESBA's consideration of longer-term professional scepticism issues. The Consultation Paper is split into 3 sections, which explore:

1. The behavioural characteristics comprised in professional scepticism;

2. Whether all professional accountants should apply these behavioral characteristics; and

3. Whether the International Code of Ethics for Professional Accountants (including International Independence Standards) should be further developed to address behaviors associated with the exercise of appropriate professional scepticism.

In looking at whether the behaviours expressed as expected of professional accountants in audit and assurance should be exercised by all professional accountants, the IESBA is of the view that because the public's expectation of the profession rarely takes into account the different roles that an individual professional accountant may be undertaking, the public believes that all professional accountants should have an impartial and diligent mindset and apply that mindset in the course of their professional activities.

Whilst the IESBA believes there is an impartial and diligent mindset expectation of the profession at large and all professional accountants that comprise it, it also recognises that the nature and extent of the actions to be taken by the professional accountant in order to demonstrate behaviour appropriate to the particular circumstances will depend upon a range of factors, including:

- The role and experience of the professional accountant.
- The type of work and degree of risk involved and, therefore, the level of expertise expected.
- The potential significance or implications of the decisions to be made on the basis of the work undertaken.
- The competence and/or likely motivation of the person providing the information being evaluated.

These considerations suggest the need to introduce scalability when considering professional scepticism.

If the consultations proposals come into place, it will apply to all professional accountants, including those in business, so Group members may wish to respond to the consultation paper – the deadline is 15 August. The paper will also form the basis for discussion with a wider range of stakeholders at a series of three global roundtables: in Washington, USA on June 11; Paris, France on June 15; and Tokyo, Japan on July 12.

Financial Reporting Council Audit Culture Thematic Review

A new report by the FRC finds high quality audit is enhanced by strong culture. PwC's Diana Hillier has the details.

The FRC considered how audit firms identify and pay attention to challenges in their culture and take action to address them to promote and sustain improvements in audit quality. It is important that audit firms create a culture where achieving high quality audit is valued and rewarded, and the importance of 'doing the right thing' in the public interest is emphasised.

The report also found that firms are investing considerable time and effort in their cultures and embedding their purpose and values in day-to-day activities. Firms also have robust processes to sanction poor quality work or behaviour.

Key areas that the FRC identified where firms should focus greater attention to establish, embed and promote an appropriate audit culture include:

- Giving additional prominence to audit-specific behaviours and values within the firms' cultural design, including the fundamental principles of integrity, objectivity, independence and professional scepticism that underpin high quality audit
- Ensuring that all audit partners and staff appreciate that a good audit is of significant societal value and helps to underpin transparency and integrity in business
- Balancing the firms' robust processes to sanction poor quality work or behaviour with better recognition of positive contributions to high audit quality
- Further developing the firms' root cause analysis techniques to identify the behavioural or cultural factors that contributed to good and poor quality outcomes
- Improving the firms' monitoring of how successful they are at embedding their desired culture, including the Independent Non Executives of the firms being more proactive when performing their assessment of the steps being taken by the firms to embed an appropriate culture.

The FRC encourages firms to provide more extensive and transparent public reporting on their culture to enhance engagement with stakeholders and to build confidence and trust. This is all valuable given the vital role audit firms play in underpinning confidence in the capital markets and their contribution to building trust in society.

This is the first time that the FRC has published a report on audit culture. Looking forward, the FRC plans to review the culture at the largest firms as part of its recently announced expanded monitoring and supervision of those firms, and encourage investors and other stakeholders to consider the link between culture and audit quality. Group members and their audit committees may find the review and its findings of interest in their dialogue with their auditors about how they embed a high quality audit culture in their firms.

The Monitoring Group issues a Feedback Statement on its consultation on reform of the international audit related standard setting model

Responses to the Monitoring Group's consultation show widespread support for reform but differences in view on the nature of it. PwC's Diana Hillier has the details.

In November 2017, the Monitoring Group (MG) of regulators that oversees the international audit, assurance and ethics standard setting bodies issued a consultation seeking views on options for some quite significant reform of the standard setting model. The nature and extent of responses exceeded the MG's expectations. As Gerben Everts, the MG Chair said, "the broad support received for the objectives set out in the consultation is a clear indication that reform of audit-related standard setting globally is needed."

The MG is encouraged by the support for the review, but also recognised that the responses to the consultation show diverse views with respect to how to accomplish the reform objectives most effectively and efficiently, and whether the reform should be carried out on a staged basis or not.

The MG plans to undertake further outreach with global stakeholders. The feedback from the consultation and further outreach will support the development of a comprehensive White Paper of reform proposals by the end of the year. The White Paper will incorporate a public interest framework, proposals on funding, an impact assessment and transition plan.

Of the 179 responses received, very few were from the corporate community. The further outreach by the MG is an opportunity for Group members to contribute their perspectives on the need for preparers to have a voice in audit, assurance and ethics standard-setting.

IAASB and US Public Company Accounting Oversight Board conduct surveys to inform their strategic planning processes

The Public Company Accounting Oversight Board (PCAOB) has sought input into its 2018-2022 strategic planning through a public survey. The IAASB has also recently launched a survey to inform its 2020-2023 plan. PwC's Diana Hillier has a brief summary.

Following the recent appointment of five new Board members, the PCAOB has taken the opportunity to take a fresh look at how the organisation is perceived externally.

Each year the organisation creates a strategic plan with a five-year outlook designed to align Board programs, operations and activities with its overall mission, goals and objectives. This year, the new Board conducted a survey to obtain the views of external parties who have an interest in the PCAOB, such as investors, auditors, preparers, audit committee members, and academics. It asked for participants' perspectives on the PCAOB's vision, priorities, and opportunities in fulfilling its mission.

The IAASB is similarly embarking on a survey to inform its next strategic plan. The survey is an important tool that helps the IAASB identify key issues for consideration in developing its future strategy. The survey seeks views and insights from all stakeholders on emerging developments and trends that are likely to be important to the Board's 2020-2023 strategy.

Although the PCAOB survey has now closed, Group members may wish to input to the IAASB's survey, which can be found here.

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150526-134115-RB-OS