Corporate
Governance
Developments
(Audit Committee Focus)

June 2013

John Roche



#### Proposed to cover

Recent UK corporate governance changes for listed companies/funds

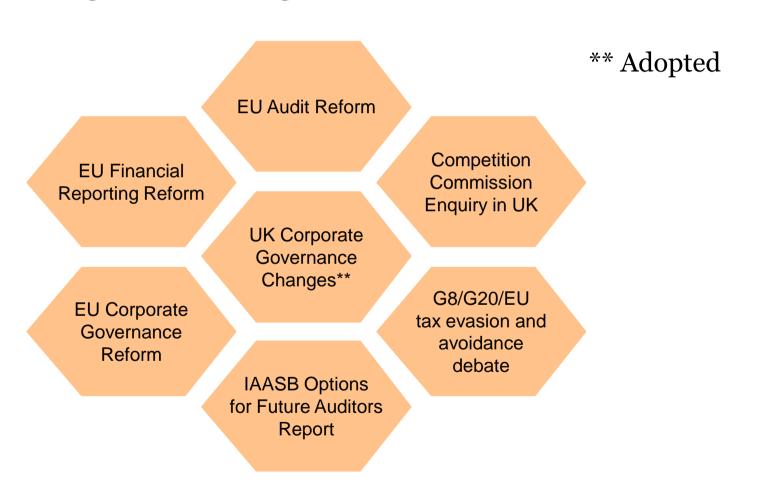
Challenges and questions for Audit Committees

Updates on "auditor reform" UK, EU etc

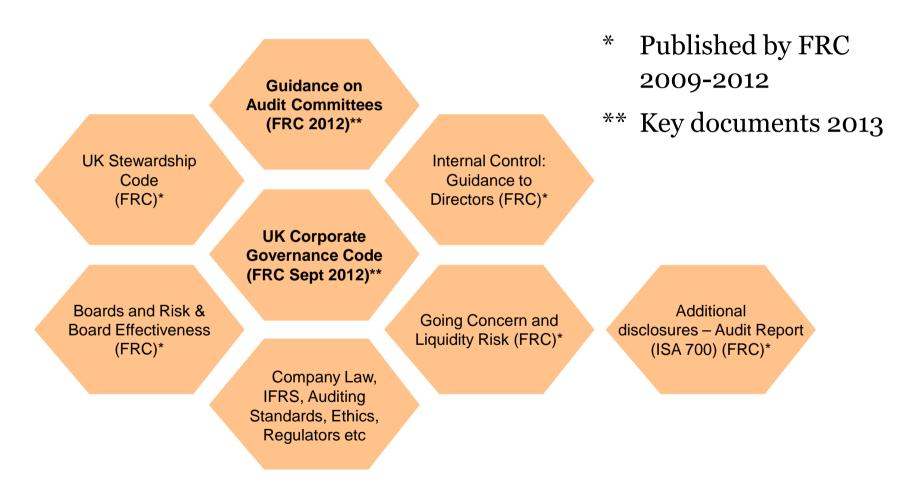
Local auditor oversight regime

Assessment of your auditor and audit quality

# Landscape for listed entities and audit committees Only some things!



### UK relevant pronouncements and guidance for audit committee members



# Recent UK corporate governance changes

UK Corporate Governance Code and Guidance on Audit Committees

#### New UK Corporate Governance Code All getting more challenging – key changes

Directors' statement that the annual report is "fair, balanced and understandable"...when requested by the Board the Audit Committee should provide advice on this

Need to consider the annual report and accounts, taken as a whole, is fair etc and provides necessary information for shareholders to assess the company's performance, business model and strategy

Consistency of front and back end and proper review done

From the user's perspective, does the annual report communicate effectively the business model, strategy and objectives, risk and control, and performance and reward and all their linkages?

What brief will the board give the AC to advise?

How does management keep AC informed on performance and strategy?

Who is responsible for making the necessary checks?

#### New UK Corporate Governance Code All getting more challenging – key changes

Code states that FTSE350 companies should put the external audit out to tender every ten years

Non binding guidance from FRC to spread the tenders over 10 years to 2022

Tendering can be deferred by directors

Current auditor can be reappointed

Purpose of tendering to "compare the quality and effectiveness..." of incumbent with other firms Has the AC considered the impact of auditor rotation?

How do you compare audit firms?

Has the AC done a proper evaluation of the auditor as part of the annual reappointment process?

How is this done and reported in annual reports?

Qualifications, expertise, resources, independence of auditor and effectiveness of external audit

# New UK Corporate Governance Code FRC guidance on tendering

The company has not tendered the audit contract or changed audit firm since 2000

Current audit partner rotates off after Dec 2014 audit

Company runs a tendering process during 2015 for the Dec 2015 year end

However the analysis changes if the company has carried out a tender or changed the audit firm in or after 2000

Current audit partner rotates off after Dec 2014 audit

New audit partner rotates on for five years

Company runs a tendering process during 2020 (or earlier) for the Dec 2020 year end

#### New UK Corporate Governance Code All getting more challenging – key changes

The audit committee section of the annual report should include "the significant issues that the committee considered in relation to the financial statements, and how these issues were addressed..."

Need for the audit committee to exercise judgment around all of the issues it has considered in relation to the financial statements and which ones were significant

Relates to significant financial reporting issues and judgments

### **Examples would surely include:**

Impairment reviews

Fair valuations of investments

Judgmental decisions on revenue recognition

Deferred tax assets and tax provisions

Compensation and litigation provisions

Going concern

#### September 2012 FRC Guidance on Audit Committees...new Bible

Summary of role of AC

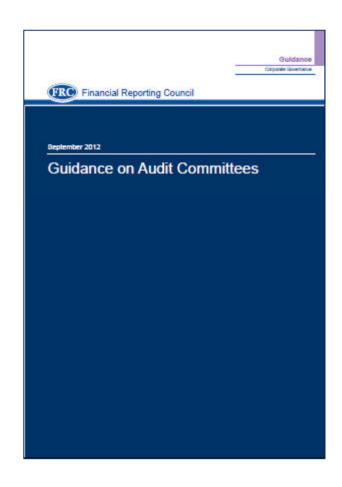
Names and qualifications of members of AC

Number of AC meetings

Significant issues considered and how addressed

How assessed effectiveness of the external audit process, approach to reappointment, tenure of audit firm, last tender date etc

Non audit services and independence /objectivity safeguards



### Diversity – so who is sitting around your board table?



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# Challenges and questions for audit committees

(Copied from Chartered Accountants Ireland publication Jan 2013)

#### Challenges for 2013

- ☐ Financial reporting process
- □ Audit market reform
- ☐ Finance talent management who is your finance function and how are you comforted it works
- ☐ Interaction with external auditor
- ☐ Interaction with internal audit (whose internal audit?)
- ☐ Oversight of internal controls and risk management
- ☐ IT and systems risk

- ☐ Regulation and compliance
- ☐ Evaluation of effectiveness of the audit committee and external audit process
- ☐ Continued poor economic outlook and impact on business, key partners used in outsourcing, liquidity, funding, performance etc

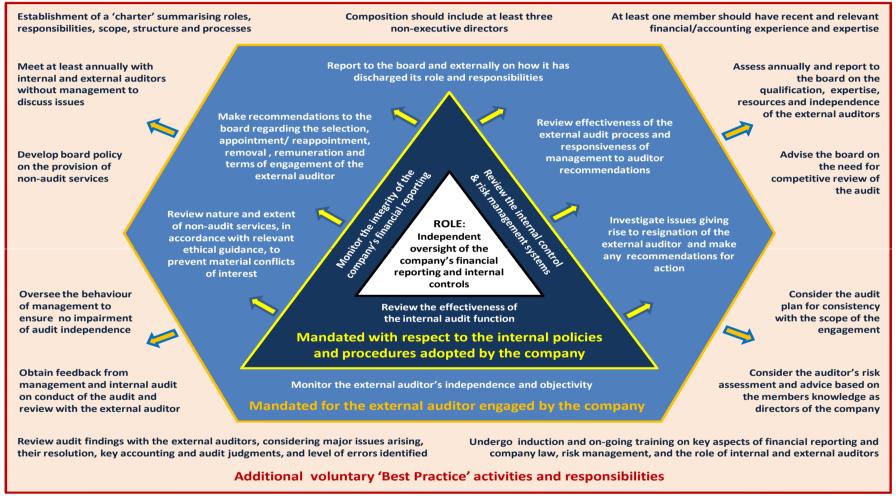
#### Some important questions?

- ☐ What information AC receive on stability of key business partners?
- ☐ Role of AC in reviewing funding and liquidity issues?
- ☐ Does "management" monitor accounting policy changes and impacts on business and accounts?
- ☐ Strategy or plan in place to adopt new standards?
- ☐ How does the AC keep abreast of regulatory developments?
- ☐ Considered auditor rotation/ tendering?

- ☐ External auditor evaluated?
- ☐ External auditor challenged significant management estimates?
- ☐ Competence of your finance function?
- ☐ Tools to monitor risk and emerging risks?
- ☐ Information on key systems and reliance on those?
- ☐ AC comfortable aware of key business compliance requirements?

### Updates on "audit reform" UK, EU etc

#### Role and functions of an audit committee in the EU<sup>1</sup>



KEY: = Mandated company internal policies and procedures and roles of the external auditor = Voluntary best practice examples

<sup>1</sup> Mandated roles and functions as set out in the EU Statutory Audit Directive, 2006 (Directive 2006/43/EC, 17 May 2006) and examples of voluntary best practice identified by the Global Public Policy Committee (GPPC)

#### European Commission proposals

- European Commission released audit policy proposals for a Directive and a Regulation on 30 November 2011
- Key proposals:
  - Mandatory firm rotation & mandatory tendering for public interest entities
  - > Audit only firms & restrictions on non-audit services
  - > PIEs required to have an audit committee
  - Broadened definition of PIEs
  - > Expanded audit report
  - > Additional report to the Audit Committee
  - > Use of ISAs for PIEs

# European Parliament committees & Council of Ministers working party

#### **European Parliament (JURI): Council of Ministers:**

- MFR on a 14 year basis, re-set if joint audit/reassessment or a tender, with longstop of 25 years
- PIE definition as in the Accounting Directive
- Audit only firms deleted
- List of prohibited services broadly IESBA; AC approval for Assurance, Tax Advisory and other non-audit services, no cap
- AC to set policy on tendering

- Wide variety of views on MFR:
  - UK for 'systemic' companiesyet to be defined
  - Germany, Sweden, Poland for financial institutions
  - France only if very long period with joint audit
- Majority want less restrictive NAS list and no cap; split views on tax services
- Further meetings before consensus reached

#### **Competition Commission**

Europe was perhaps waiting to see this...

31% of FTSE100

20% of FTSE250

#### Same audit firm for more than 20 years...

- ✓ Significant hurdles in way to compare offering of current auditor with competitors
- ✓ Difficult for companies to judge audit quality in advance due to nature of the audit
- ✓ Companies and audit firms invest in mutual relationship which is hard to walk away from
- ✓ Management face significant time costs to select and educate a new auditor
- ✓ Mid tier firms face experience/reputation barriers to expand and selection in FTSE350 market
- ✓ Auditors in the pockets of management when servicing management demand

#### **Competition Commission**

Possible remedies for the UK audit market...

- ✓ Mandatory tendering
- ✓ Mandatory rotation of audit firms
- ✓ Expanded remit/frequency of AQRT (AIU) reviews
- ✓ Prohibit Big 4 Only clauses in loan documents

- ✓ Strengthen accountability of the external auditor to the audit committee
- ✓ Enhanced shareholder auditor engagement
- ✓ Extended reporting requirements
- ✓ New FRC to be given a secondary duty to promote competition between firms providing audits to FTSE 350 companies

### Local audit oversight regime

# Guernsey/Jersey auditor oversight regime Applies to auditors of EU market traded companies only

- ✓ All auditors to Guernsey/Jersey incorporated companies which have equity or debt listed on EU recognised exchanges must be registered with the Guernsey Registry or JFSC
- ✓ Audit firms also required to register with various EU audit oversight bodies where those EU exchanges are based
- ✓ Introduced in April 2010 and mirrors EU Audit Directive

- ✓ June 2013 received EU approval of our regime as equivalent (6 years)
- ✓ Delegated review of audit firms and the quality of their work to AQRT or QAD depending on number of audit clients firm by firm
- ✓ No public reporting of results of audit quality reviews
- ✓ Companies reviewed get notified and receive a private report from the UK regulator on the quality of the audit performed

### Assessment of auditor and quality

#### Quality assessment (know it when you see it?)

- ✓ Guide on Audit Committees has some helpful commentary
- ✓ Annual assessment on qualification, expertise and resources, independence and the effectiveness of the external audit process
- ✓ Report on the firm's own internal quality control procedures
- ✓ Annual published transparency report
- ✓ AQRT reports where available

- ✓ Satisfaction survey from management
- ✓ Independent senior partner review
- ✓ Meetings with key management as the audit progresses
- ✓ Significant issues reported to the audit committee and interaction with the audit committee
- ✓ Evidence of challenge of management and audit scepticism around significant estimates and judgements

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