

Governance *in focus*
2013: Raising the bar for
audit committees



Contents

"All change" as we start 2013	1
Audit Committee scope to be extended in 2013	2
Time for audit committees to put judgements into focus	3
Judgement hot topics for this reporting season	4
Should you go early on changes to audit committee reporting?	6
The Deloitte Academy – Update for Audit Committees	8

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“All change” as we start 2013

2013 is set to be a busy year in the governance area. There are a number of proposals and consultations expected over the coming months. All changes and proposals revolve around a similar theme – enhancing transparency and facilitating better engagement with shareholders.

Area	Status	Impact
UK Corporate Governance Code and FRC Guidance on audit committees	Revised version issued in September 2012 – effective for periods commencing on or after 1 October 2012.	<p>New requirements include:</p> <ul style="list-style-type: none"> • a new statement from the board as to whether the annual report is fair, balanced and understandable; and • enhanced reporting by the audit committee of key issues, judgements and the external auditor relationship. <p>See Governance in brief – September 2012 for more detail.</p>
Going concern	Lord Sharman presented his recommendations to the FRC last summer. The FRC issued a consultation paper on implementation of the Sharman Panel recommendations at the end of January with a comment period ending on 28 April 2013. The proposed effective date for the new guidance is periods commencing on or after 1 October 2012 with early adoption encouraged.	<p>Under the proposals the 2009 guidance for directors is replaced by new guidance, applicable to all companies, which includes the following key changes:</p> <ul style="list-style-type: none"> • the going concern assessment should be integrated with on-going business planning, risk management and management of the business; • the assessment period becomes the “foreseeable future” which is a period of at least twelve months from approval of the financial statements but has no maximum and should reflect business and economic cycles; • the assessment process is to focus on both solvency and liquidity risks; and • new guidance on the threshold for disclosure of material uncertainties. <p>A supplement for banks is also included within the paper which aims to clarify the position of liquidity support from central banks.</p>
“Turnbull III”	A consultation on changes to the Guidance on Internal Control is expected in the second quarter of 2013 once the going concern consultation has been completed.	We expect the consultation will focus on matters such as strategic risks and risk reporting.
Narrative reporting	Draft regulations were issued by BIS in October and there was a one month consultation period. The final regulations should be published in the spring and are likely to be effective for periods ending after 1 October 2013.	Based on the draft regulations, a new Strategic Report will be introduced broadly replicating the existing Business Review but with additional disclosures on strategy, business model, diversity and human rights. It is suggested that the Strategic Report may replace the Summary Financial Statements.
Auditor reporting	The comment period on the IAASB’s Invitation to comment on its ‘Improving the audit report paper’ closed in October and we await next steps.	The IAASB is exploring inclusion in the audit report of additional information to highlight matters that, in the auditor’s judgement, are likely to be most important to the users’ understanding of the audited financial statements or the audit as well as an explicit opinion on going concern.

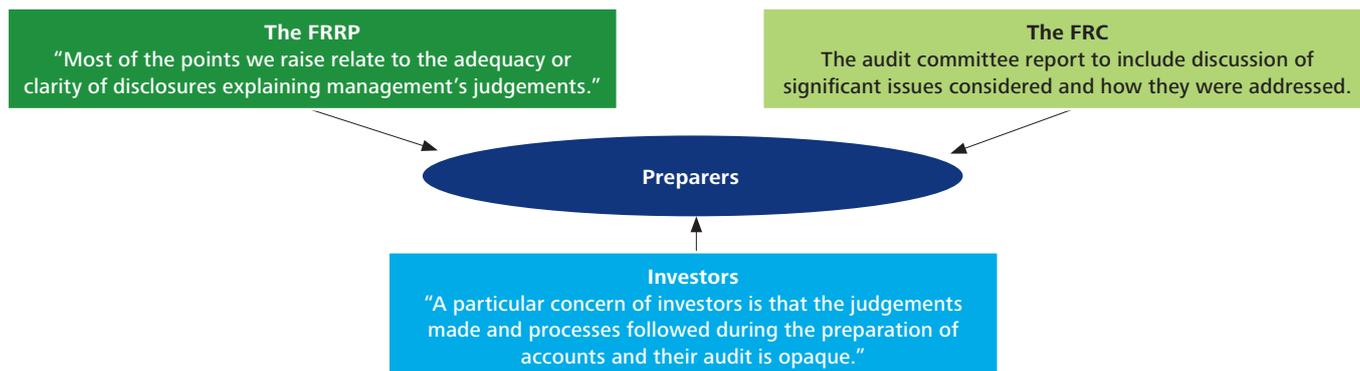
Audit Committee scope to be extended in 2013

The changes described above will considerably extend the scope of the audit committee's responsibilities.

Area	Broader responsibilities	How to respond
Financial reporting	<ul style="list-style-type: none"> • Consideration of the broader narrative report. • Review of the business model and strategy. • Challenge of management judgements. 	<ul style="list-style-type: none"> • Early discussion with the board on the audit committee role in relation to the narrative report. • Agree a process for reviewing the disclosures of the business model and strategy formally during the board or audit committee cycle. • Greater audit committee oversight and understanding of all key judgements and related disclosures. • Fuller disclosure in the audit committee report on activities of the committee, and of work, conclusions and disclosures on reporting judgements.
Audit	<ul style="list-style-type: none"> • Assessment of the effectiveness of the external audit process. • Scrutiny of non-audit services. • Disclosure on tenure and tendering policy and timings. 	<ul style="list-style-type: none"> • Do not forget that all decisions taken in respect of the auditor relationship will need to be fully transparent – think about how they would be reported in the national press. • Be clear what “good” looks like in terms of audit quality and effectiveness. • Ensure there is plenty of scope for full and frank discussions with your auditors on scope and all key judgements.
Risk	<ul style="list-style-type: none"> • More consideration of strategic and reputational risks. • Increased focus on risk reporting and mitigating activities undertaken. • Compliance slip ups can lead to reputational damage. • Technology risks, data, security of heightened importance. • Extended enterprise risks – third parties – can tarnish your reputation. 	<ul style="list-style-type: none"> • Review the internal audit work plan – is it focussed on the right areas? Does it address all of the strategic risks? • Ensure compliance is getting appropriate attention – consider your company’s attitude to compliance failures – are there consequences? • Plan your risk disclosures early – the FRC’s Company Reporting Review (formerly the FRRP) could be sending a letter if the disclosures do not focus on principal risks only, are too generic or the disclosure does not set out mitigating activities. • Consider sessions on technology and “extended enterprise” risks during the year.

Time for audit committees to put judgements into focus

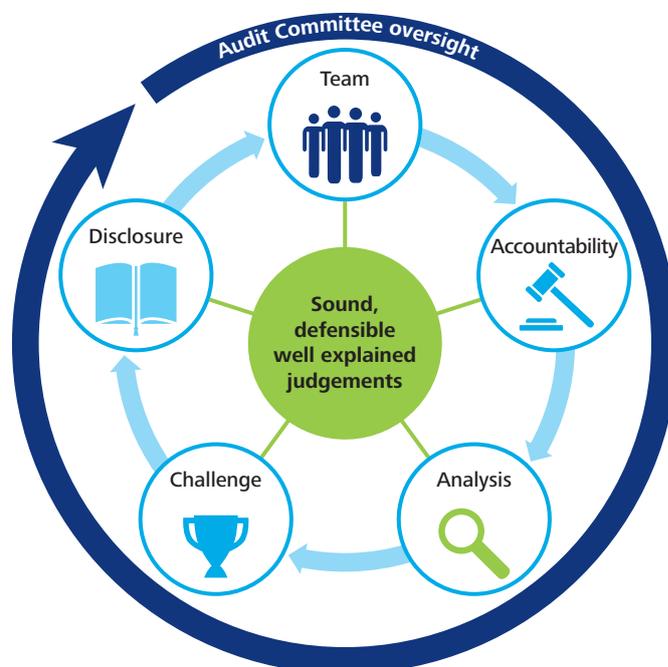
The pressure for audit committees to focus on judgements is coming from a number of different angles.



To help audit committees to ask the right questions on judgements and to ensure that those judgements are sound, defensible and well explained, it is important to have a robust framework in place.

The audit committee can use the following framework as a benchmark for what should be in place.

	<p>Team</p> <ul style="list-style-type: none"> Consider quality of people involved, their incentives, whether a multi-disciplinary team might be required and/or the need for external experts.
	<p>Accountability</p> <ul style="list-style-type: none"> Allocate responsibility for each judgement and define reporting mechanisms and facilitate early engagement with independent external experts.
	<p>Analysis</p> <ul style="list-style-type: none"> Consider relevant accounting literature, perform fact gathering, financial analysis and benchmarking. Where appropriate, include sensitivity analysis, stress testing and consider alternative outcomes.
	<p>Challenge</p> <ul style="list-style-type: none"> Consider quality of management information and judgement tracking including an assessment of the consistency of the analysis and impact of the judgement.
	<p>Disclosure</p> <ul style="list-style-type: none"> Consider disclosure and communication requirements throughout, including benchmarking of disclosures and consistency with disclosures on business model, market and strategy.



Judgement hot topics for this reporting season

In our view hot topics will fall into the following broad categories:

Revenue recognition	<ul style="list-style-type: none">• Little change in terms of accounting standards for some years but now coming back onto the agenda as a result of the new revenue exposure draft.• May require, for many companies, detailed contract-by-contract reviews and refreshing of accounting policy disclosures, if not restatement.• Policies and estimation techniques need regular review to respond to evolving business models and changes in the ways in which products and services have been delivered and priced in response to challenging economic conditions.• Other complexities include unbundling of bundled services and agent versus principal.
Provisions	<ul style="list-style-type: none">• Provisioning remains a highly judgemental area due to the need to support significant “unknowns” that may include aspects that are outside the company’s control.• Discounting is often an area of pitfall – don’t forget that “risk weighting” can be reflected in cash flows or in the discount rate, but not both, and that reflecting risk in the discount rate reduces the rate (and increases the provision) as this is often overlooked.• Consider early engagement with legal and other advisors to position the company with the best rationale for the provision recorded.
Exceptional items	<ul style="list-style-type: none">• There is always significant judgement as to what represents an “exceptional item” or a “non-recurring” gain or loss.• Accounting policies may not be clear and thus create the risk of “earnings management” and interaction with management incentives.• Common areas of debate include taking severance costs as an exceptional when the role is being replaced in the business and/or grouping of costs that are not dissimilar in order to meet a quantitative threshold for recognition as exceptional when the costs relate to quite different business activities.
Deferred tax	<ul style="list-style-type: none">• Despite sometimes being described as “fictional” or “accounting” assets, regulators take deferred tax assets as seriously as any other accounting entry.• Common challenges include the assessment of the likelihood of future taxable profits when the entities concerned have a history of losses and the outlook period over which it is considered probable that such taxable profits will exist.• Take care to use forecasts that are consistent across accounting judgements – using one set of assumptions when deciding whether to record a deferred tax asset and another when considering impairment of a related intangible asset or goodwill is open to challenge.
Transfer pricing	<ul style="list-style-type: none">• Cross border tax matters are frequently hitting the headlines.• There is an increasing level of challenge by tax authorities.• NGOs and consumer groups are increasingly mobilized – watch social media.• Perform a risk assessment and ensure your planning is robust and defensible.
Going concern/ financing and impairments	<ul style="list-style-type: none">• A common pitfall is failing to ensure that the same forecasts are used for impairment reviews, going concern assessment and for deferred tax asset recognition. Inconsistent forecasts do not stack up and their use may give rise to material accounting differences.• Need to consider use of external data points to validate forecasts – consider how fine the judgement is – and how much value for example, in impairment reviews is “down the road” in the terminal value.

Goodwill impairment reviews

The European Securities and Markets Authority (ESMA) has published a report on impairment testing practices and disclosure of goodwill which includes the following findings:

- A fall in market capitalisation below book value is an indication that an impairment of goodwill has occurred.
 - Where there has been a fall in market capitalisation below book value, ESMA would expect to see disclosures on sensitivity analysis.
 - Only 60% of the sample selected disclosed the key assumptions for cash flow forecasts.
 - Where fair value less costs to sell is used for recoverable amount, ESMA would expect more weight to be given to external sources of information rather than entity specific assumptions.
 - Use of overly optimistic growth rates was observed based on current growth forecasts for the overall economy.
 - Approximately 25% of issuers in the sample disclosed an average discount rate rather than a specific discount rate for each CGU
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Should you go early on changes to audit committee reporting?

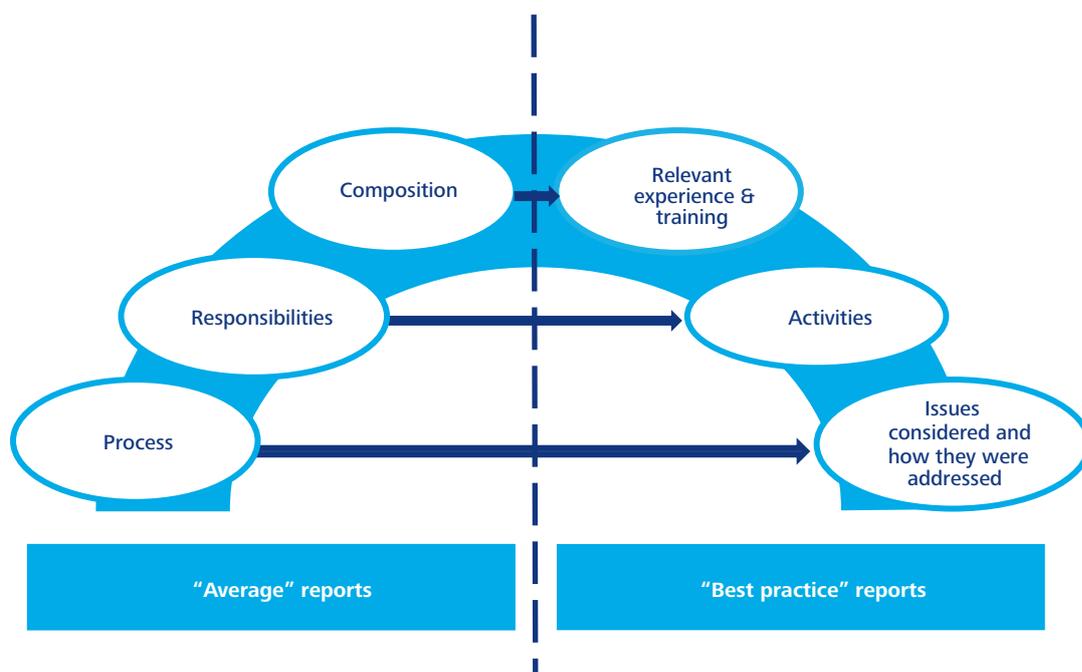
In their response to the FRC on the Effective Company Stewardship consultation, the Investment Management Association (IMA) made the following comment:

“A particular concern of investors is that the judgements made and processes followed during the preparation of accounts and their audit is opaque. Indeed the audit committee plays an important role in this and whilst there are many communications between it and the auditors, these are rarely communicated to investors.”

The IMA's response goes on to refer to the Enhanced Disclosure Guidelines which were put together by a working group including representatives from bodies such as Standard Life, Hermes and RailPen. They are designed principally for boards and audit committees when preparing their audit committee reports.

The focus of the Enhanced Disclosure Guidelines is principally around key judgements, e.g. the valuation of assets and liabilities, write downs and impairment provisions, securitization, off- balance sheet and contingent liabilities. The clear request from this investor community is for disclosures which are “engaging, informative and useful”.

The call from many investors is for audit committee reports to give much more of a flavour and insight into the work of the committee and its conclusions. This means moving away from “average” audit committee reporting which would typically set out information on the composition of the committee (usually just the names of the members), the responsibilities of the committee (usually just a repeat of the terms of reference and/or the relevant provision of the UK Corporate Governance Code) together with some detail on activities in the year and details of policy as regards engagement of the external auditors.



The call is now for “Best practice” reports to tackle the requirements from a different angle in an “engaging, informative and useful” manner, to enable investors to engage in discussions on the key issues. Rather than just names of members there is discussion of relevant experience and training. Rather than a repeat of the terms of reference there is an explanation of the actual activities undertaken to discharge the committee’s responsibilities. Instead of a description of process, there is discussion of the key issues which have been considered during the year and how they were addressed.

Early adoption areas

Significant issues considered	<ul style="list-style-type: none"> • A good number of companies have started early with disclosure on the significant issues considered. • The challenging part is explaining how these issues have been addressed, particularly in giving some guidance on the range of outcomes and sensitivities. • Audit committees should engage early with the Finance Director and the auditors on these significant issues. • In future, drafting of the Audit Committee Report will need to start much earlier in the audit process.
External auditor relationship	<ul style="list-style-type: none"> • There is a new Code provision (C.3.7) which calls for enhanced disclosure around the external auditor relationship. • There should be disclosure of the length of tenure of the external audit firm and the date when a tender was last conducted. • The audit committee must also explain how it has assessed the effectiveness of the external audit process.

FRC call for participation in a Lab to develop Audit Committee Report best practice

Before Christmas the FRC’s Financial Reporting Lab announced that it would be undertaking a project on audit committee reporting with the aim of facilitating the sharing of views between preparers and investors on what would be useful information. The Lab hopes to produce a report in the summer. Anyone interested in participating should contact the Financial Reporting Lab.

The Deloitte Academy – Update for Audit Committees

The Deloitte Academy has been designed for main board directors of listed companies. The Deloitte Academy provides support and guidance to boards, individual directors and company secretaries of listed companies through a programme of briefings and update sessions. Bespoke training for the whole board or individual directors is also available.

We have recently delivered the material in this update in a recorded session at the Deloitte Academy.

If you are a member of the Deloitte Academy, you can access the recording from the Deloitte Academy website.

If you are not a member, and would like further details about the Deloitte Academy, including membership enquiries, please email enquiries@deloitteacademy.co.uk

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