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Governance *in brief*
FRC issues 2016 UK Corporate Governance Code, Guidance on audit committees and changes to auditor independence rules – Part One

Headlines

- The FRC has completed its 2016 updates to the UK Corporate Governance Code and to standards for auditors, which finalises its implementation of the EU Audit Regulation and Directive. It has also issued updated Guidance on Audit Committees. These take effect for financial years commencing on or after 17 June 2016.
- The changes to the UK Corporate Governance Code are minimal – there is now a provision that the audit committee as a whole is required to have competence relevant to the sector in which the company operates and the provision relating to the need to tender the external audit every 10 years has been removed, as this is now superseded by the CMA and EU requirements for mandatory tendering and rotation of the audit firm.
- The changes to the Guidance on Audit Committees are more substantial and cover both audit committee activities and reporting. Audit committee terms of reference are likely to require a refresh as a result of these changes.

Background to the changes

In 2014 the European Parliament approved a new regulatory framework on audit reform composed of Directive 2014/56/EU (amending earlier Directive 2006/43/EC) and Regulation 537/2014 (the "Directive" and the "Regulation"). This new framework was published in the Official Journal of the European Union and entered into force on 17 June 2014. The UK and other member states have been working towards implementation of this EU Audit Regulation and Directive by the effective date of 17 June 2016. The legislation applies to companies with financial years commencing on or after 17 June 2016 – so for a calendar year end company, it will first apply throughout the year ending 31 December 2017.

Both the FRC and BIS consulted on matters requiring changes to the UK Corporate Governance Code and the Guidance on Audit Committees, the Ethical Standards for Auditors and International Standards on Auditing (ISAs) and changes to legislation respectively during 2016. BIS has not yet published updated legislation following its consultation.

This Governance *in brief* focuses on the updates to the UK Corporate Governance Code and the Guidance on Audit Committees. Part Two, focusing on changes to auditor independence rules, will be issued shortly.

Although the revised UK Corporate Governance Code, Guidance on Audit Committees, Auditing Standards and Ethical Standard are marked as "final draft", no further changes are anticipated before they take final effect.

Outcome of the consultation process

For those who are familiar with the content of the FRC consultation 'Enhancing Confidence in Audit', the key changes relating to the UK Corporate Governance Code, the Guidance on Audit Committees and the International Standards on Auditing applicable in the UK and Ireland are included in the following table and all significant amendments are then examined in more detail below.

2016 UK Corporate Governance Code	• In relation to composition of the audit committee, a decision to retain the term "recent and relevant financial experience" rather than the proposal for "competence in accounting and/or auditing".
Guidance on Audit Committees	• The head of internal audit should be (expected to be) invited regularly to attend meetings of the audit committee (joining the finance director and the external audit partner as expected invitees). • If risk management and internal control responsibilities are delegated to different committees the board should consider the impact of splitting those responsibilities. • A responsibility to consider the clarity of audit committee reporting and to be prepared to meet investors has been introduced to ensure that shareholder interests are properly protected in relation to financial reporting and internal control. • There are additional reporting requirements for the audit committee to explain in its report how the audit committee composition requirements have been addressed and also how the audit committee has assessed the effectiveness of internal audit.
International Standards on Auditing	• These now implement a number of IAASB standards. • Enhanced audit reports will have to explain to what extent the audit was considered capable of detecting irregularities, including fraud.

2016 UK Corporate Governance Code – changes for audit committees

The FRC has issued an updated version of the UK Corporate Governance Code, applicable to companies reporting on their compliance with the Code either under the Listing Rules requirements or voluntarily. The changes are driven by the Competition & Markets Authority's final Order as well as the EU Audit Regulation and Directive.

This is a 'light touch' update with changes only to section C.3 (Audit Committee and Auditors):

- The audit committee as a whole will need competence relevant to the sector in which the company operates. This is likely to affect induction processes and future recruitment policies.
- The FTSE 350 audit tendering provision has been removed as this is superseded by the CMA and EU requirements for mandatory tendering and rotation of the audit firm.
- The audit committee report within the annual report is now required to provide advance notice of any plans to retender the external audit.

2016 Guidance on Audit Committees – changes to recommended activities and reporting

In addition to changes which bring the Guidance in line with the proposed changes to the Code, there are the following amendments to audit committee activities and to audit committee reporting.

Activities

Area	Guidance
Key judgements	The audit committee should consider key matters of its own initiative rather than relying solely on the work of the external auditor. It must satisfy itself that the sources of assurance and information it has used to carry out its roles to review, monitor and provide assurance or recommendations to the board are sufficient and objective.
Responsibility for risk management and internal control systems – clarification	The board has ultimate responsibility for an organisation's risk management and internal control systems, but the board may delegate to the audit committee some functions to assist the board in meeting this responsibility.
Internal audit process	This section has been updated to reflect existing good practice, including that the internal audit plan is aligned to the key risks of the business. The audit committee should ensure the internal auditor has a reporting line that enables it to be independent of the executive and so be able to exercise independent judgement. The audit committee should ensure that the internal audit function has unrestricted scope and evaluates the effectiveness of the risk, compliance and finance functions as part of its internal audit plan. The audit committee may also wish to consider whether an independent, third party review of internal audit effectiveness and processes is appropriate.
External auditor	The audit committee should have primary responsibility for negotiating the fee and scope of the audit, initiating a tender process, influencing the appointment of an engagement partner and making formal recommendations to the board on the appointment, reappointment and removal of the auditors (reflecting the CMA Order). More emphasis is placed on interactions with the external auditor around the areas of significant judgement and risks to audit quality.
Non-audit services	Set and apply a formal policy specifying the types of non-audit service for which use of the external auditor is pre-approved. The guidance reaffirms that such approval should only be in place for matters that are clearly trivial.
Protecting shareholder interests	The audit committee has a role in ensuring that shareholder interests are properly protected in relation to financial reporting and internal control. The committee should consider the clarity of its reporting and be prepared to meet investors.
Remuneration of audit committees	Remuneration should reflect the responsibility members bear and that a significant extra amount of time needs to be committed.

Additional disclosure in audit committee reports

The Guidance on Audit Committees has introduced a number of new disclosures which reflect the changes to the Code and the new activities described above. Some of the disclosure changes are also designed to meet the needs of investors more directly and reflect the findings of the FRC's Financial Reporting Lab's project on Reporting of Audit Committees.

- How the audit committee composition requirements have been addressed.
- How the performance evaluation of the audit committee has been conducted.
- The current external audit partner's name and for how long the partner has held the role.
- Advance notice of any plans for retendering of the external audit.
- The committee's policy for approval of non-audit services.

- The audit fees for the statutory audit of the company's consolidated financial statements and the fees paid to the auditor and its network firms for audit related services and other non-audit services, including the ratio of audit to non-audit work.

- For each significant engagement, or category of engagements, an explanation of the services provided and why the audit committee concluded that it was in the interests of the company to purchase them from the external auditor.

- An explanation of how the committee has assessed the effectiveness of internal audit and satisfied itself that the quality, experience and expertise of the function is appropriate for the business.

- The nature and extent of interaction (if any) with the FRC's Corporate Reporting Review team.

- When a company's audit has been reviewed by the FRC's Audit Quality Review team, disclosures about significant findings and the resulting actions they and the auditors plan to take. This disclosure should not include the audit quality category awarded.

These disclosures are expected to be included in the audit committee report within the annual report and unfortunately there is no indication in the Guidance that it is acceptable to provide any of the disclosures on a website. However, the Guidance does say that the section need not repeat information disclosed elsewhere in the annual report, as long as 'signposts' are provided to the information. This will be helpful for boards seeking to keep information on matters such as the annual performance evaluation of the board and its committees in the same place.

A challenge for drafting audit committee reports will be ensuring that all of the new disclosures remain fresh each year and do not introduce too much repetitive material.

CMA Order – a reminder

We have noted a number of December 2015 audit committee reports which have not included the statement of compliance with the Order – for FTSE 350 companies, this is a requirement of the legislation. In order to provide this compliance statement, it is worth remembering the updates to audit committee responsibilities included in the Order, notably the role of the audit committee in supervising and agreeing the scope of the audit. The Order also provides that audit committees must authorise provision of any non-audit services by the statutory auditor, although allows for the pre-approval of permitted non-audit services with materiality thresholds set based on the value of the services.

Changes to auditing standards – the enhanced audit report

Key changes to auditing standards include the requirement for 'enhanced auditor reporting' for all PIEs and all listed companies. A PIE is a public interest entity, defined in EU law as being an entity governed by Member State law with securities (debt or equity) admitted to trading on an EEA regulated market (including LSE Premium or Standard Listing, not AIM), a credit institution (bank or building society in UK terms) or insurance undertaking. The change will also affect UK and Irish companies with listings outside the UK and Ireland, including entities with listed debt, as well as all unlisted banks, building societies and insurance undertakings. Previously only the auditors of companies required to provide a statement of compliance with the Code by the Listing Rules or voluntarily providing such a statement were required to issue an enhanced audit report.

There will also be some changes to the contents of the enhanced audit report which may add to the length of reports, including:

- an expansion of the auditor's description of key audit risks and their response to include, where relevant, key observations arising with respect to those risks;

- a description of the extent to which the audit was considered capable of detecting irregularities including fraud;

- disclosure of the auditor's tenure, including previous reappointments and renewals of appointment (such as success in a competitive audit tender); and

- a declaration of the auditor's independence, including confirmation that no prohibited services were provided.

Some changes are also made to auditor's reports on all entities, whether listed, PIE and/or neither:

- an explicit requirement to include in the auditor's report a statement of the auditor's conclusion on the going concern basis of accounting;
- a revised description of the scope of an audit; and
- for statutory audits, an opinion as to whether the directors' report and any strategic report have been prepared in accordance with the legal requirements. This is not an audit of the content of these reports and is limited to confirming that the relevant information has been produced.

For further information:

The final drafts of the FRC's 2016 UK Corporate Governance Code, Guidance on Audit Committees, Ethical Standard and International Standards on Auditing (UK & Ireland), together with supporting material, are available at:

Final Draft: UK Corporate Governance Code 2016 – **https://frc.org.uk/Our-Work/Publications/Corporate-Governance/Final-Draft-UK-Corporate-Governance-Code-2016.pdf**

Final Draft: Guidance on Audit Committees 2016 – **https://frc.org.uk/Our-Work/Publications/Corporate-Governance/Final-Draft-Guidance-on-Audit-Committees-2016.pdf**

Revised Auditing Standards 2016 – **https://www.frc.org.uk/Our-Work/Audit/Audit-and-assurance/Standards-and-guidance/Standards-and-guidance-for-auditors/Revised-Auditing-Standards-2016.aspx**

Revised Ethical Standard 2016 – **https://frc.org.uk/Our-Work/Audit/Audit-and-assurance/Standards-and-guidance/Standards-and-guidance-for-auditors/Revised-Ethical-Standard-2016.aspx**

Other materials released alongside those final drafts:

Press release – **https://www.frc.org.uk/News-and-Events/FRC-Press/Press/2016/April/Revised-UK-Corporate-Governance-Code,-Guidance-on.aspx**

Feedback Statement and Impact Assessment: Consultation – enhancing confidence in audit – **https://frc.org.uk/Our-Work/Publications/Audit-and-Assurance-Team/Feedback-Statement-and-Impact-Assessment-Consulta.pdf**

Investor Briefing Note: Implementation of the Audit Regulation Directive – **https://frc.org.uk/Our-Work/Publications/Corporate-Governance/Investor-Briefing-Note-Implementation-of-the-Audi.pdf**

Deloitte View

- We welcome the finalisation of the 2016 UK Corporate Governance Code, the Ethical Standards and the International Standards on Auditing applicable in the UK and Ireland in advance of the implementation date. We recognise this has been a challenging exercise and that not all member states will meet the timetable.
- Nomination committees and boards will need to determine whether the audit committee is constituted appropriately for the new requirements. Succession planning should be carried out where necessary to ensure there is sufficient depth of sector competence in the non-executive director population and succession matrices may need updating.
- Audit committees should assess whether their terms of reference need to be amended for these changes. Some companies will already have updated their terms of reference earlier in 2016 and will now need to consider repeating the exercise.
- Given the number of new reporting requirements, audit committees and the group company secretary need to plan ahead on meetings agendas to ensure all matters are covered and plan the new content requirements for the annual report.

The Deloitte Academy

The Deloitte Academy provides support and guidance to boards, committees and individual directors, principally of the FTSE 350, through a series of briefings and bespoke training. Membership of the Deloitte Academy is free to board directors of listed companies, and includes access to the Deloitte Academy business centre between Covent Garden and the City.

Members receive copies of our regular publications on Corporate Governance and a newsletter. There is also a dedicated members' website **www.deloitteacademy.co.uk** which members can use to register for briefings and access additional relevant resources.

For further details about the Deloitte Academy, including membership, please email
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