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On the audit committee agenda 2018

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Governance in focus

On the audit committee agenda
– the 2018 reporting season

Contents

Welcome to our audit committee supplement for 2018 reporting

Foreword from William Touche

Dear Audit Committee Member,

The last few weeks of 2017 were active ones for the Financial Reporting Council, and we are therefore supplementing our comprehensive November round-up "On the Board Agenda – 2018" with a summary of the additional pertinent matters for audit committees to inform 2017/18 annual reports.

On the board agenda: the 2018 reporting season covered a wide variety of topics, from company purpose, the board's responsibilities under s172 and interactions with shareholders and stakeholders, to executive pay and corporate governance reform, risk and crisis management, and internal and external audit.

In early December, the FRC published its consultation on a new-style UK Corporate Governance Code, shorter, sharper and more modern, with a renewed focus on Code principles. Also in December we published a Governance in Brief on the proposed reforms to help you identify and navigate the proposed changes. Alongside the proposed revised Code the FRC published updated Guidance on Board Effectiveness and some questions on the Stewardship Code. Also in December the Investment Association published its Public Register, recording significant shareholder dissent against proposed resolutions and where companies have withdrawn resolutions at a late stage.

In this Audit Committee Supplement we focus in particular on the FRC's Financial Reporting Lab's report on risk and viability reporting, examining the FRC's call to separate the discussion on long term prospects and viability, and the call for a much greater time horizon on prospects. We also touch on the FRC's Audit and Assurance Lab's report on audit committee reporting in annual reports and the FRC's Audit Quality Review team's thematic review on materiality.

Do get in touch with your Deloitte partner or email our governance team if you want to discuss any of these matters further.

Yours faithfully,

William Touche

January 2018

Reporting on risk, longer term prospects and viability

In this article we explore the FRC's Financial Reporting Lab's report on risk and viability reporting.

In summary, the risk management section of annual reports is highlighted as being of great value to investors, but investors have been disappointed that many companies have restricted their discussion of prospects and viability to a "safe" three year period. The FRC and investors are now calling for a separation of the discussion of prospects over a longer term, from the viability statement which is increasingly perceived as a qualified extension of the going concern assessment.

Risk and viability reporting – understanding principal risks is critical

The FRC's Financial Reporting Lab issued its latest report, Risk and viability reporting, in November 2017. It is a useful read and examines the key attributes of principal risk and viability reporting, their value and use to investors, as well as providing illustrative examples of reporting favoured by investors.

Investors consulted as part of the project are unanimous that understanding the principal risks faced by a company is important both before making an investment and during the holding of that investment.

A change in risk faced by a company is one factor that may cause an investor to change the size of their shareholding.

In addition, investors want a better indication that companies are looking at the long term. They find that few companies currently use the viability statement as a means of communicating messages about the long-term prospects of the company, treating it rather as an extended going concern confirmation.


LAB

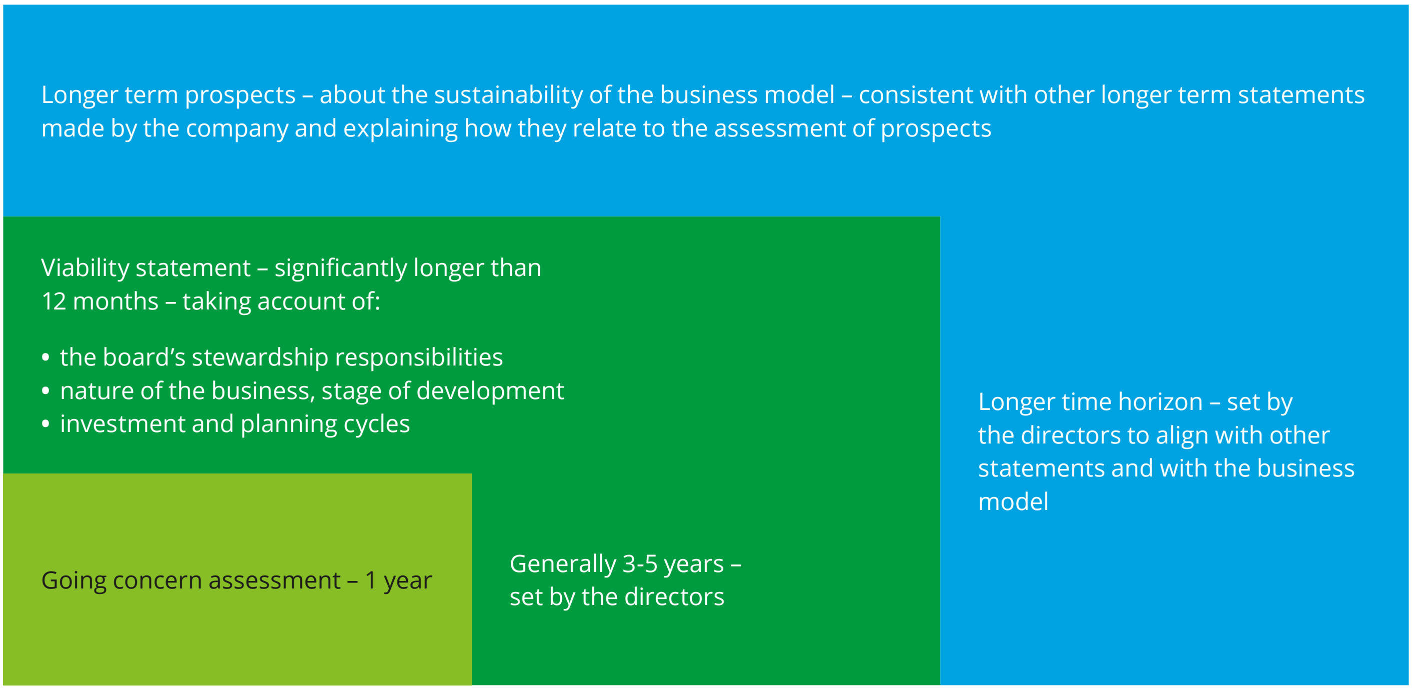
Lab project report:

Risk and viability reporting

November 2017

FRC Financial Reporting Council

Figure 1. Time periods for assessing and reporting on a company's future



Principal risk reporting

Attribute	Comment
Categorisation of principal risks	Clear categorisation of principal risks to identify those which are company specific and those which are more general (e.g. industry risks) is helpful.
The priority of principal risks	Where there is no obvious ordering of risks (for example by category), investors have said that they assume that the first risk on the list is the most important to the company.
Movement in principal risks	Disclosures which show only a direction of travel (an increase or decrease in the year) are commented on less positively than those which explain the context and cause of the movement.
Linkage to other parts of the annual report	It is important to show how the principal risks fit into the disclosures on business model and/or strategy.
Likelihood & impact	Many investors comment that current practices in the use of heat maps do not provide sufficiently precise information to be of much benefit and would prefer some narrative description to provide further explanation.
Risk appetite	Investors recognise that risk appetite is very difficult to articulate succinctly and say that it is possible to get a feel for a company's risk appetite from the annual report without having an explicit statement attempting to explain or quantify it.
Presentation of risks as gross or net of controls	Investors did not express a clear preference for whether risk is presented before the application of control activities (gross) or after it has been reduced by the application of control activities (net). The emphasis from investors was that companies need to be clear about which basis they are using when disclosing information around principal risks.
Responsible party & mitigating activities	Investors like to know where responsibility for principal risks lies in the organisation as they are interested in how the board responds. Companies should pay attention to how they describe mitigating activities.
Brexit, cyber and climate change	Investors want to understand how longer term risks such as these might impact the company, but they should only be included as principal risks if they are genuinely principal risks for this company.

The Financial Reporting Lab's suggested questions for companies on their principal risk disclosures

- Does the description of principal risks identify how they are specific to the company?
- Is it clear how the company categorises and prioritises principal risks?
- Are movements in principal risks, including movements into and out of the principal risk classification, explained?
- Is it clear how the principal risks link to other parts of the annual report and accounts, in particular the viability statement, business model, strategy, KPIs and the risk reporting in the financial statements?
- Do the mitigating activities include specific information that allows the reader to understand the company's response?

Viability statement reporting

Attribute	Comment
Time horizons	Investors are looking for information which is consistent with other time horizons in the annual report, e.g. strategic and business cycles, debt repayments, lease periods, intangible asset amortisation periods, capital investment periods and technology development periods. In their letter to Audit Committee chairs in October 2017, the FRC has therefore suggested that longer term prospects should be discussed separately with a clearly identifiable separate period from the viability statement where companies have typically opted for a 3-5 year horizon.
Work performed	Some companies include disclosures in their annual report which describe the work performed by the directors around the viability statement. Investors highlight this type of disclosure as helpful in providing context for the disclosure and understanding the extent of oversight from the board on the assessment process and annual report disclosure.
Prospects	The sustainability of the business model is a key consideration for longer term prospects and investors expect the directors to be able to discuss its resilience to risk and adaptability to market challenges. Investors also highlight the various timescales discussed by companies in annual reports, investor presentations and during other meetings, and want to understand how these relate to the assessment of prospects.
Stress and sensitivity analysis	Most investors highlight that disclosures around stress and sensitivity analysis are useful although current practice is often too high level. Investors are particularly positive about disclosures that provide specific insight into the scenarios considered, including how they link back to the principal risk disclosures.

The Financial Reporting Lab's suggestions on viability statement disclosures

- Does the disclosure differentiate between the directors' assessment of long term prospects and their statement on the company's viability?
- When disclosing the long-term prospects has the board considered their stewardship responsibilities, previous statements they have made, especially in raising capital, the nature of the business and its stage of development, and its investment and planning periods?
- Does the viability statement disclose any relevant qualifications and assumptions when explaining the directors' reasonable expectation of the viability of the company?
- Is the link between the viability statement and principal risks clear, particularly in relation to the scenario analyses?
- Are the stress and scenario analyses disclosed in sufficient detail to provide investors with an understanding of the nature of those scenarios, and the extent and likelihood of mitigating activities?

The full Lab report is available at **https://frc.org.uk/getattachment/76e21dee-2be2-415f-b326-932e8a3fc1e6/Risk-and-Viability-Reporting.pdf**.

For a comprehensive picture of narrative and financial reporting trends for UK listed companies, together with ideas to help improve annual reports, please access our **Annual report insights 2017** at **www.deloitte.co.uk/annualreportinsights**.

Upcoming Financial Reporting Lab projects

The Lab is seeking involvement from companies, analysts and investors for a project exploring how companies measure performance against their strategic objectives and how financial and non-financial metrics can be most usefully presented. Interested parties should contact the Lab by 31 January 2018.

For the audit committee agenda

How far will you adopt the Lab's clear guidance on prospects and viability this year?

Is the discussion of longer term prospects linked to business model and other longer term assumptions in the annual report? Are the key strategic assumptions clearly articulated?

Are longer term prospects discussed over a much longer period than that used for the viability statement assessment? Are the downside scenarios and key underpinning financial assumptions in the viability statement clearly articulated?

Is the risk management discussion prioritised and is the disclosure on mitigation or management of principal risks accurate? Does the annual report convey a balanced view, avoiding painting too rosy a picture in vulnerable areas?

Non-financial reporting – an update

This article explores the current status of the FRC's Guidance on the Strategic Report and some details of their frequently asked questions on non-financial reporting changes in the UK which derive from the EU's Non-Financial Reporting Directive (NFR Directive). Remember the NFR Directive is applicable to all companies reporting now – i.e. periods commencing on or after 1 January 2017.

The FRC announced in December that it is delaying the publication of its updated Guidance on the Strategic Report until after the Government has announced its legislative changes in respect of s172 reporting, expected around March 2018.

In the interim, it has published helpful **Frequently Asked Questions** to clarify some key elements regarding implementation of Non-Financial Reporting in the UK.

A reminder of the reporting obligations

All public interest entities (PIEs) that have over 500 employees either in the company itself or in the group headed by the company need to meet the new non-financial reporting requirements in their annual report. The first of the FRC's FAQs includes a flow chart to help companies understand which strategic report changes apply to them.

As a reminder, a PIE is a public interest entity, defined in EU law as being an EEA 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.

Changes to the Companies Act sections referring to the strategic report mean that, where material, companies now have to report on the impact of the company's activities, describe the policy, explain due diligence performed and describe the outcomes of the policy during the year in respect of the following areas:

- environmental matters (including the company's impact on the environment);
- employees;
- social matters;
- respect for human rights; and
- anti-bribery and anti-corruption.

What are the changes?

The FRC's FAQs helpfully summarise the additional or amended disclosure requirements that apply to quoted companies, where material, notably:

- disclosing information relating to anti-bribery and anti-corruption;
- adding due diligence disclosures, which explain the steps taken by the company to ensure that company policies in the relevant areas are adhered to and the outcome of their due diligence;
- providing an explanation if there is no company policy on the matters listed above; and
- for principal risks in particular, disclosure of business relationships, products and services which are likely to cause adverse impacts – a look beyond the company's own operations.

The FAQs clarify that the non-financial information does not need to be presented in a separate statement within the strategic report but should be integrated and flow as part of the narrative.

The FRC highlights that "reporting on the impact of activities is an area which will require companies to exercise judgment and [they] expect best practice to evolve over a period of time." It also continues to encourage companies to implement reporting on the directors' duty under s172 of the Companies Act 2006 in this reporting season.

Further information

To access the FRC's Frequently Asked Questions on Non-Financial Reporting, visit: **https://www.frc.org.uk/getattachment/c3b4e267-ef24-4c91-8427-4aa18b697c25/FAQs-on-non-financial-reporting.pdf**

For recent news items and publications on Non-Financial Reporting, see **https://www.iasplus.com/en-gb/collections/narrative-reporting/news-items-on-the-eu-non-financial-reporting-directive**

For the audit committee agenda

Has your audit committee discussed changes to the annual report arising from non-financial reporting legislation and identified the changes that affect your company?

Does the strategic report demonstrate that the board is looking beyond the company to identify adverse impacts arising from the interrelationship of its business relationships, products and services and the outside world? Useful perspectives can be gained from stakeholders – are these taken into account when preparing company disclosures?

Does the board perform what might be reasonably addressed as due diligence assessments in the relevant areas? If so, is there sufficient focus on the quality of data in these non-financial areas, where data quality is not always subject to the same controls as financial data? The quality of data is of course highly influential in confidence in the outcome of a board's assessment.

Audit committee reporting – shorter, sharper, more focused

In this article we explore the results of the first phase of the project run by the FRC's newly established Audit & Assurance Lab, whose mission is to promote best practice on audit related issues by engaging with relevant stakeholders, including audit committees, companies, investors and auditors.

This first phase focused on audit committee reporting in the annual report; the second will focus on the reporting provided to audit committees by external auditors, with this phase expected to report in the first half of 2018.

Audit Committee Reporting focuses on the good practice elements of existing audit committee reporting, including several best practice examples in the publication.

Overall comments from investors regarding high-quality audit committee reporting include:

- audit committees could do more to bring out key messages, which could be done in an introductory statement from the chair;
- significant issues addressed by the audit committee regarding the financial statements should be easily identifiable and understandable; and
- more concise reporting is more likely to be read, enabling key information to be identified by investors.

Reporting on significant issues

On significant issues affecting the financial statements, investors want disclosure to provide:

- context of the issue, including quantification where appropriate;
- a description of the actions the audit committee has taken during the year;
- the audit committee's conclusion on each issue and the underlying reasons for that; plus
- relevant cross-references to elsewhere in the annual report.

Some investors compare the audit committee report to the external auditor's report to understand whether there are any differences in views on the significant issues.

Internal control, risk management systems, and internal audit

Investors seek clarity within the audit committee report on the role the audit committee takes in these areas and any other key committees or board-level decisions. This can be supported by helpful and informative cross-referencing to elsewhere in the annual report where these topics are discussed more fully.

Engagement of audit committees with investors

The report also discusses the quality of engagement between investors and audit committees and how this can be improved. Both audit committee chairs and investors thought more could be done here.

Some suggestions include:

- ensuring the audit committee report is accessible and does not include too much boilerplate, so that investors will read it in advance of meeting with the audit committee chair and the meeting will therefore be more focused and valuable;
- investors meeting the audit committee chair during governance roadshows, or as part of ongoing engagement with the company; and
- audit committees approaching their largest shareholders prior to tendering the audit – those investors who replied to companies that did this were recognised to make thoughtful contributions which assisted during the tender process.

Disclosures regarding the external auditor

Appointment and tendering	Investors seek confirmation in the annual report that audit quality is paramount when selecting or reappointing the auditor. Information on audit fees is helpful to enable investors to judge the level. Investors want to understand how any conflicts of interest have been resolved or mitigated prior to appointment. Early detail on plans for audit tendering – investors also welcome separate engagement on this topic.
Independence and objectivity	When audit committees discuss objectivity, it is helpful to include the committee's observations regarding the auditor demonstrating the appropriate mindset, including professional scepticism. Investors seek sufficient information on non-audit services fees and policy, including the audit committee's explanation of why they chose the auditor as a provider if material non-audit services were provided.
Effectiveness	Investors seek clear information on how the audit committee has assessed the effectiveness of the external auditor within its assessment of the audit process. Providing detail on the audit committee's conclusions and rationale is helpful here. Investors would also like disclosure on the relationship between the auditor and the audit committee.

Further information
To access the FRC's Audit Committee Reporting: Audit & Assurance Lab Project, visit: **https://frc.org.uk/getattachment/7f97f065-d912-4ca0-a96b-1f2fd4b0a565/LAB_Final.pdf**.

For our observations on audit committee reporting and corporate governance reporting trends for UK listed companies, together with ideas to help improve annual reports, please access our **Annual report insights 2017** at **www.deloitte.co.uk/annualreportinsights**.

For the audit committee agenda

Does your audit committee chair write a personal introduction to the audit committee report?

Is it clear, from reading the audit committee report, why the significant issues relating to the financial statements were deemed to be significant, what challenges the audit committee raised on those issues and what the conclusion was?

Is your audit committee chair taking the opportunity to meet with investors to discuss any issues on a timely basis?

Materiality and unadjusted errors

In this article we explore the outcomes of the FRC's Audit Quality Thematic Review on materiality, which includes calls from investors for audit committees to provide more "colour" around adjusted and unadjusted misstatements raised by the auditor, thus offering insight on how aggressive or prudent the company is on financial reporting matters.

Audit committees should understand and challenge materiality judgements

"Audit Committees should consider how best to engage with investors on materiality and adjusted and unadjusted differences. They should also ensure that their own reporting provides sufficient information on the discussions held with auditors regarding these differences." FRC's Audit Quality Thematic Review: Materiality

In December 2017, the FRC issued its Audit Quality Thematic Review on materiality. It examined how the auditor:

- assesses materiality across the financial statements as a whole (overall materiality);
- reduces to an appropriately low level the probability that the aggregate of misstatements identified through their audit work exceeds overall materiality (performance materiality);
- assesses materiality for particular entities or business activities included within the financial statements (component materiality); and
- amends materiality for particular classes of transactions, account balances or disclosures (also performance materiality).

Key messages for audit firms

Some key messages for audit firms which may inform audit committee queries on materiality are set out below:

Area	Key messages
Adjusted profit as a benchmark	Explain why the adjustments were made and how the benchmark selected better responds to the needs of the users of the financial statements.
Component materiality	Guidance should be provided to teams including how to respond to the size and risk of the component.
Performance materiality	Provide better explanations of the concept of performance materiality and the difference between materiality and performance materiality in auditor reports.
Loss-making entities	Guidance should be provided to teams on how to make materiality judgements when an entity is loss-making.
First year audits	Consider whether a lower performance materiality is appropriate for first year audits.

Key messages for audit committees

The FRC has incorporated a full appendix of key messages for audit committees into the report. These are comprehensive and bring out discussions to be held both with management and with the auditor. Of particular importance are:

- Understand and challenge the basis for the materiality levels set and the benchmark used including, in particular, how these reflect the **needs and expectations of users** of the entity's financial statements.
- Understand how auditors are ensuring that materiality is being determined appropriately at **group and component levels**, particularly where issues or changes have arisen in a specific component.
- Understand why management have not adjusted the financial statements for **uncorrected misstatements** brought to their attention by the auditors and instruct management to make the relevant adjustments where appropriate.
- Understand whether **disclosure omissions** reported to them by the auditors have arisen through error or a specific management judgment and assess whether the inclusion of the disclosures concerned is likely to provide material information to users of the financial statements.
- Assess whether the information included within the audit committee report could be improved to provide additional **clarity and insight** on the judgments made in preparing the financial statements.

There is also a helpful section on insights from investors, which notes that all investors at the FRC's round table discussions were keen for audit committees to provide more "colour" around adjusted and unadjusted misstatements raised by the auditor, thus offering insight on how aggressive or prudent the company is on financial reporting matters.

The FRC's report is available at **http://www.frc.org.uk/getattachment/4713123b-919c-4ed6-a7a4-869aa9a668f4/Audit-Quality-Thematic-Review-Materiality-(December-2017).pdf**.

For the audit committee agenda

Do you understand how the auditor sets materiality, performance materiality and component materiality? Do you discuss materiality changes during the year?

Do you have discussions about unadjusted misstatements and disclosure omissions? Do you discuss these in the Audit Committee report in the Annual Report?

Are there any updates that you wish to make to how you assess the effectiveness of your external auditor or to the disclosures in the audit committee report in the light of the FRC's thematic review?

What to expect in 2018?

As the Government's corporate governance reform package progresses and the FRC continues to publish more guidance on corporate governance, corporate reporting and audit, we thought it would be helpful to summarise what we are expecting in the near future. There is a lot to look forward to and of course we will keep you current on significant topics as they develop.

What is new/approved?

- On 25 May 2018, the General Data Protection Regulation comes into force.
- The FRC has announced the topics for its corporate reporting thematic reviews for the coming year. These are:
  - smaller listed and AIM company reporting (the FRC will write to 40 companies informing them it will review aspects of their annual reports);
  - interim reporting under the new IFRSs on revenue and financial instruments;
  - the expected effect of the new IFRS on lease accounting; and
  - the effects of Brexit on principal risk disclosures.
- The FRC has issued new guidance for auditors on preliminary announcements. A key change is a new voluntary report to accompany preliminary announcements that can be issued by the auditor setting out the status of the audit and the procedures performed. Audit committees may wish to include an auditor's report in their preliminary announcement and, if so, can facilitate the process by engaging early with their auditor.

What is under consultation?

- The London Stock Exchange is consulting on AIM rules changes until 29 January. On corporate governance, it proposes changing Rule 26 to introduce a requirement for AIM companies to comply or explain against a recognised industry code, aiming to offer meaningful corporate governance information to investors.
- The Quoted Companies Alliance is working on revisions to its Corporate Governance Code for Small and Mid-Size Quoted Companies. For companies with less appetite for the full implications of being premium listed, AIM provides a useful alternative.
- The FRC's consultation on the proposed new UK Corporate Governance Code, Guidance on Board Effectiveness and some questions on the Stewardship Code will conclude at the end of February.

What is planned?

- The government has announced that James Wates CBE will be chairman of a group that is working to develop a new set of corporate governance principles for private companies.
- In March / April, we are anticipating secondary legislation from the Government on topics including s172 reporting and reporting the ratio of executive pay.
- The FRC will publish its updated Guidance on the Strategic Report following that legislation and will follow up with its proposed new Code in June after it has digested the views of respondents to the current consultation.
- The FRC's Audit and Assurance Lab will be publishing a report on the second phase of its project, focusing on the auditor's private reporting to audit committees.
- In summer 2018, the GC100 plans to publish new advice and guidance on the practical interpretation of the directors' duty under s172.

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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 enquiries@deloitteacademy.co.uk.

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Designed and produced by The Creative Studio at Deloitte, London. J14720