FTSE100 conversation with auditors

Audit Committee Institute

Six insights arising from the ACI FTSE100 conversation with auditors - 19 January 2017

Headlines

Many audit committees are refining their agendas, oversight processes and composition to address heavy workloads. However, efficiency and effectiveness increasingly hinges on spending time outside of the boardroom visiting company facilities, interacting with employees and customers, and hearing outside perspectives.

In a world where increasing public disquiet about standards in business life can threaten a company's licence to operate, there are legitimate questions as to how directors discharge their legal duty to have regard for a wide group of stakeholders while acting to promote the success of the company for the benefit of its members.

With the regulators citing increased investor engagement as a policy objective, in reality, the dialogue between the investor community and audit committee chairs is less than ideal.

Alternative Performance Measures (APMs) rooted in the way the board actually view the business are of value to investors. However, the FRC's recent thematic review calls for companies to do more to ensure that such measures are clearly defined and reconciled and the reasons for their use explained.

Experience of data analytics within the audit is mixed. There is some anecdotal evidence of overpromising and under delivering, but others cite a step change in audit approach post audit transition.

From an auditor perspective the work of the FRC's Audit Quality Review Team (AQRT) is well received and helping the profession drive audit quality higher.

1. A changing audit committee for a changing world?

A recurring theme was the current political and economic turmoil where "the only thing that is constant is change". How do audit committees factor in macro-geopolitical considerations into their work? Equally, how do audit committees get sufficient assurance around major internal change programmes whether that be finance, HR or technology related?

To address heavy workloads, many audit committees are focusing on ways to improve their efficiency and effectiveness - including refining their agendas and oversight processes, and reassessing their skills and composition. Keeping pace requires agendas that are manageable (what risk oversight responsibilities are realistic given the audit committee's time and expertise?); focusing on what's most important (starting with financial reporting and audit quality); allocating time for robust discussion while taking care of 'must do' compliance activities; and ensuring the committee has the right composition and leadership. Leading audit committees recognise that the committee's efficiency and effectiveness in the boardroom increasingly hinges on spending time outside of the boardroom - visiting company facilities, interacting with employees and customers, and hearing outside perspectives - to truly understand the tone, culture, and rhythm of the organisation.

Attendees also questioned their responsibility as directors under section 172 (s172) of the Companies Act 2006. It is well understood that directors should have regard for a wide group of stakeholders while acting to promote the success of the company for the benefit of its members. However, in a world where increasing public disquiet about standards in business can threaten a company's licence to operate, there are legitimate questions surrounding both the interpretation of the law and the extent to which a board (or audit committee) should be transparent as to how it discharges its duties. Attendees queried the extent of the external audit role in providing assurance on compliance with s172.

Section 172 and the auditor

The purpose of the Strategic Report as required by the Companies Act 2006 is to inter alia help members assess how the directors have performed their duty under section 172 (duty to promote the success of the company). Auditing Standards require that auditors perform such procedures as are necessary in their professional judgment to identify:

- Any material inconsistencies between the other information included in the annual report (including that in the Strategic Report) and the financial statements;
- Any material inconsistencies between the other information included in the annual report (including that in the Strategic Report) and the auditor's knowledge obtained during the course of the financial statements audit; and
- Whether the information in the Strategic Report (and the Directors Report and Corporate Governance Statement) appears to be materially misstated in the context of the auditor's understanding of the legal and regulatory requirements applicable to the statutory other information.

2. Is an audit committee role becoming a less attractive proposition?

Increased regulation and a more intense spotlight from the Financial Reporting Council (FRC), as well as additional risks brought about by digitalisation and technological disruption, can all add to the "mission creep" that audit committees are increasingly experiencing. A question was raised as to whether non-executives will be less inclined to take on an audit committee role going forward. "It's a big question given the lack of public trust in business" and "the sense that directors are trying to hoodwink the regulator".

The ability of audit committees to adapt their modus operandi was also raised. "It's important to focus on the right thing, but equally it's really difficult to get that right!" How often the committee meets and the duration of those meetings can be both company specific or down to particular circumstances. For example, one attendee noted that the audit committee is currently meeting every month because to provide oversight over a big change programme. Others spoke of limiting the duration of each meeting to "something manageable" – though experience ranged between three and six hours. It was acknowledged that in the financial services sector, some of the tasks have been re-assigned to the risk committee. "Clarity on agenda items is vitally important, as well as not allowing presentations to be too long. A good audit committee chair will seek to run their agenda in that way."

The volume of reading matter and board papers was also raised. The advent of digital board and committee papers has sometimes encouraged the inclusion of very long appendices, but "a 2000 page audit committee paper is not terribly helpful".

3. Investor expectations

The debate around audit committee-investor relations is an area that has surfaced for discussion several times during ACI breakfasts. With the regulator citing increased investor engagement as an objective, we continue to hear that, in reality, the dialogue between the investor community and audit committee chairs is less than ideal. "Investors rarely want to speak to the audit committee!"

One guest recalled writing "to the 10 largest investors when we were going out to tender but we didn't hear back from anyone".

Adrian Stone, Head of Audit for KPMG in the UK, explained how KPMG have been talking to the investor community to better understand their perspective on audit, reporting and governance. Key themes arising have included audit materiality and Alternative Performance Measures (APMs) – both areas where more transparency and "greater colour" are sought.

Attendees noted that when investors do meet with the audit committee chair, it tends to be someone from their governance team. "Senior fund managers would not contemplate reading accounts, it's regarded as an unrewarding activity for them. The asset managers are happy as long as things are not going wrong - what really interests them is company performance and that does not necessarily correlate with governance."

4. Telling the company story

Telling the company story has become even more important against the backdrop of volatility arising from Brexit and other recent events. "It's about being clear about what you do or don't do." APMs are very much part of this storytelling, along with non-financial KPIs – and a recent KPMG survey of 50 FTSE350 interim reports showed that companies are changing the presentation of their APMs. However, the FRC's recent Thematic Review of APMs is explicit in its call for companies to "ensure that such measures are clearly defined and reconciled and the reasons for their use explained. Discussion of APMs can never be a substitute for discussion of the results as determined in accordance with IFRS."

Some attendees noted that investors themselves are increasingly using APM modelling to better understand performance; and that APMs can also be used to compare companies within a business sector - providing there is clarity as to how the measures are calculated.

Of course, APMs should be rooted in the way the board actually view the business i.e., the best measures for understanding the success of the company's strategy. Boards need confidence in the probity of such measures (via an appropriate assurance framework) regardless of whether they are externally communicated.

5. Data and analytics

The innovation agenda continues to develop at a pace and data analytics is increasingly being used as a differentiator in the competitive tender environment. However, the experience of attendees was somewhat mixed. "I've yet to see data and analytics tell me something that we don't already know." Some attendees also cited audit firms over-promising and under-delivering in respect of their data analytic capability remarking, "in a tender, things get promised such as data and analytics and you expect to see huge scale benefits. However I've actually seen very little benefit so far - despite the promises made", and "I've seen a step change in audit approach when there has been a change in auditor."

Other attendees considered that data and analytics ought now to be seen as 'business as usual' – but auditors and audit committees alike need to ensure that much more data translates to more useful and reliable information for both parties. "The benefits should be much wider than just making audits more efficient."

6. Audit quality

Audit quality was discussed – in particular whether the work of the FRC's Audit Quality Review Team (AQRT) was having a positive impact. From an auditor perspective, the AQRT reviews appear to have been well received and are helping the profession raise the bar.

At the latest ACI Technical updates, we surveyed our members on audit quality. We asked attendees to anonymously rate various aspects of audit quality for their organisation's most recent financial year. The areas looked at included the auditor' focus on risk assessment, quality management, demonstration of challenge, level of independence and communication. 116 audits - both internal and external – were assessed. The highest rated area, for both internal and external audits was that of auditors exhibiting independence and objectivity (4.5 out of 5 and 4.2 out of 5 respectively), with an overall view of audit quality being rated as 4.1 for external audit and 3.9 out of 5 for internal. See our paper on this survey here.

KPMG hosts
Richard Broadbelt
Stephen Cooper
Tim Copnell
Anna Jones
Paul Korolkiewicz
Pamela McIntyre
Adrian Stone

Additional upcoming event:

We are delighted to welcome Sir Iain Lobban for our FTSE100 **'Conversation about cyber risk – a growing threat'** which is taking place on Thursday 14 September 2017 at Number Twenty.

A former Director of the UK security and intelligence organisation GCHQ, Sir Iain will lead a discussion on addressing the growing threat of cyber risk. One of the biggest risks that confronts today's corporate world, it is a new threat, unbounded by geography and set to escalate as more goes online and as the barriers to entry for criminals come down.

Tea and coffee is from 7:45am, with breakfast served at 8:00am, closing by 9:30am. If you would like to register please email us or contact us on 020 7694 8855.

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