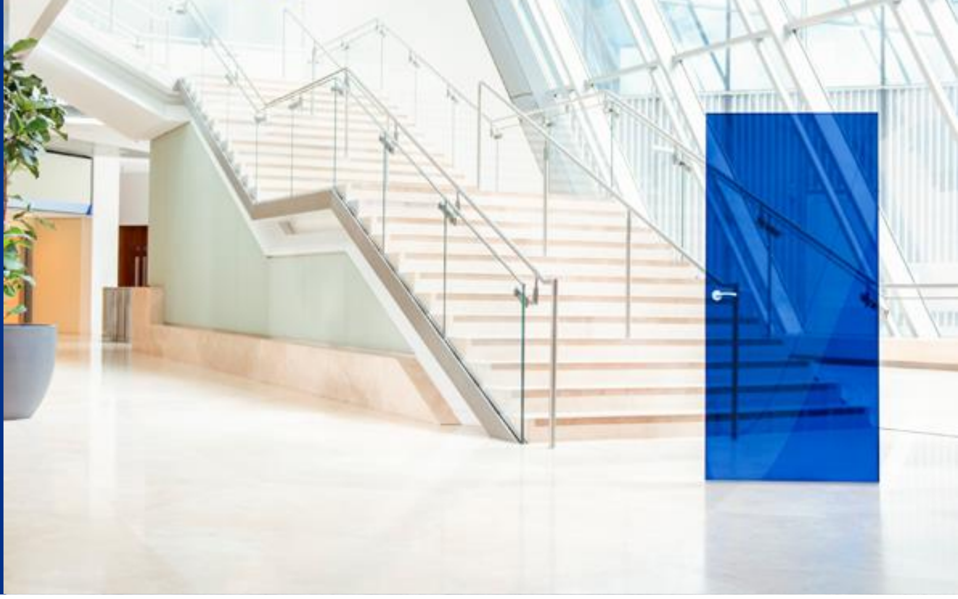
A conversation with the ACCIF about internal controls

KPMG Audit Committee Institute



Following on from previous sessions with Sir Donald Brydon and Sir Jon Thompson, we were delighted to welcome Jock Lennox and Chris Jones from the Audit Committee Chairs Independent Forum (ACCIF) to lead a conversation with our FTSE100 Audit Committee Chairs Group about the progress towards a stronger UK framework for reporting on internal controls over financial reporting.

In his review of the quality and effectiveness of audit, Sir Donald Brydon acknowledged that the effectiveness of internal controls is of great relevance to the reliability of a company's financial reporting and he put forward a recommendation for directors to report more meaningfully on their internal controls over financial reporting. He recommended that a CEO/CFO attestation should be introduced supported by principles developed by the ACCIF.

In response to that recommendation, an ACCIF Board led working group with input from subject matter experts, has developed draft proposals. In doing so, the ACCIF has sought to:

- Build on existing UK practice rather than adopt an overseas framework unfamiliar in the UK.
- Be proportionate – balancing the cost of implementation and ongoing monitoring with the desired benefits.
- Avoid being duplicative - where an organisation already applies a framework such as Sarbanes-Oxley, Spanish ICFR or Japanese SOX there should be no additional requirements.

In the context of building on existing UK practice, the ACCIF is proposing that it leverages Listing Rule 8.4.2(4) which requires that the directors of a company seeking a Premium Listing on the Main Market have to establish procedures that provide a reasonable basis for them to make proper judgements on an ongoing basis as to the financial position and prospects of the company and group. The proposal, however, is to limit the attestation to the Financial Position rather than a company's prospects.

The ACCIF proposals have been shared with the FRC, the large number of audit committee chairs who are ACCIF members, and other stakeholders such as audit firms, the Accounting Institutes, the 100 Group and representatives from the investor community.

Responses to date, including those from both Sir Donald Brydon and Sir John Kingman, have been broadly supportive in terms of the direction of the proposals although there is debate around some of the implementation detail. Certain organisations, including those from the investor community are yet to respond.

The discussion that followed focussed primarily on the areas of greatest debate including:

- The scope and application
- Timing of implementation
- Accountability and enforcement

The question of independent assurance was taken off the discussion table though it was noted that the Big 4 and ICAEW were in favour of 'mandatory' independent assurance while audit committee chairs were generally of the view that it should be for them to decide as part of the rolling Audit and Assurance Policy recommended by Brydon.

Scope and application

There was a thorough debate as to whom the proposals should apply - FTSE100, FTSE350, all premium listed or all PIEs. Attendees had different views including:

- All premium listed companies – they should already have complied with Listing Rule 8.4.2(4,) albeit perhaps many years ago, and are subject to other internal control 'requirements' imposed by the UK Corporate Governance Code.
- All PIEs – though the definition of 'public interest' needs looking at again as many organisations currently captured by the definition are not demonstrably in the public interest.
- All quoted companies - if people can buy equity stakes in a company, then they may well expect it to have robust controls. "Would not including them pass the Daily Mail test?".

— Restricted to a narrower index like the FTSE350, as companies at the smaller end of the quoted market may have a more limited public interest whereas there are some private companies so large that they would fall into this definition more clearly

It was recognised that there are complications that need thinking through to address companies moving in and out of the index. A transition period of some sort would be sensible.

Implementation timetable

Attendees stressed the importance of a realistic transition period with several noting that the documentation and rigour around testing, necessary to support a public attestation on the effectiveness of controls, is not there yet for many companies.

Some attendees suggested a minimum of one financial year as too long a lead time may make it seem less important; others suggested it should be as long as three years – a year to design, a year to test and a year to report.

The confluence of the pandemic, global recession and Brexit was, for some, an argument for a longer timeframe; others noted that "life can't stop" and that in such stressed times it was more important than ever that internal controls should be robust and provide confidence for shareholders and other stakeholders.

One attendee anticipated difficulties in engaging qualified firms to help with implementation noting that companies would be unable to turn to their external auditor due to independence rules.

A final thought was that there could be a staggered timetable where smaller companies might be given more time to comply.

Point in time attestation

Some attendees challenged the proposed 'point in time' attestation provided by the CEO and CFO, noting that under the UK Corporate Governance Code and associated guidance, the boards report on their review of the effectiveness of risk management and internal control addresses the systems that have been in place for the year under review and up to the date of approval of the annual report and accounts – i.e., not a 'point in time' statement.

The ACCIF's position was that, if the attestation went beyond the SOX 'point in time' requirements, then it would be more onerous than SOX as a control framework.

Accountability and enforcement

Sir Donald Brydon's recommendation was that CEOs and CFOs should attest to the Board that an evaluation of the effectiveness of the company's internal controls over financial reporting had been completed and that those controls were effective (or not if that were the case). The Board would then report to shareholders that it has received such an attestation from the CEO/CFO.

Some attendees were uncomfortable with the concept of a public CEO /CFO attestation and questioned whether it fits with the UK's unitary board concept. *"We have other statements such as the viability statement which are the board's responsibility. The concept that the UK wants a regulatory regime requiring assurance by the CFO fits uneasily with a principles-based regime."*

Others were also supportive of the unitary board concept suggesting that boards would naturally look for assurance from internal audit (and potentially external audit) and hold the executive to account – and that that is preferable to individual accountability.

By contrast, the ACCIF (and some attendees) spoke about directors being prepared to be held to account in order to improve confidence in a company's control framework, which was the purpose of these changes. *"We need to be prepared to play our part, even if means moving from principles to a rules-based approach."*

Reference was also made to the banking and insurance sectors where it was suggested that the SMR may have made it more difficult to find individuals to serve on Boards. *"The expectations of the PRA and FCA have evolved over the years. The expectations placed on non-executive directors are now similar to those of an executive … but without the pay!"*

Some attendees noted that successive corporate failures had led to cries of "where were the auditors" while board members and executives had gone unsanctioned. There was sympathy for addressing this asymmetry by being more explicit that the primary responsibility falls on the company, its management and the board. "*This will not be seen to have teeth or be credible if there is no impact for CEOs and CFOs when things go wrong.*"

Others referenced Sir John Kingman's recommendation that the new regulator should hold all directors to account, not just those with an 'accounting' qualification. *"It is totally illogical that you can only be sanctioned based on whether you are an accountant. You've taken on the job and therefore you should be regulated."*

Some final thoughts

US SOX was an arduous process, but it did provide companies with an opportunity to redesign their control frameworks for the better. "*We used to have 1,300 flabby key controls - now have 500 muscular controls.*"

A proportionate and phased approach would be welcome, but ultimately robust internal controls over financial reporting should already exist – whatever company you are. It is in the approach to documentation and evidencing where the UK could be more proportionate than the US standards.

And finally, while independent assurance was outside the scope of this discussion, KPMG noted that there are strong arguments that independent assurance has been the catalyst for driving control improvements rather than the traditional UK approach of self-reporting.

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