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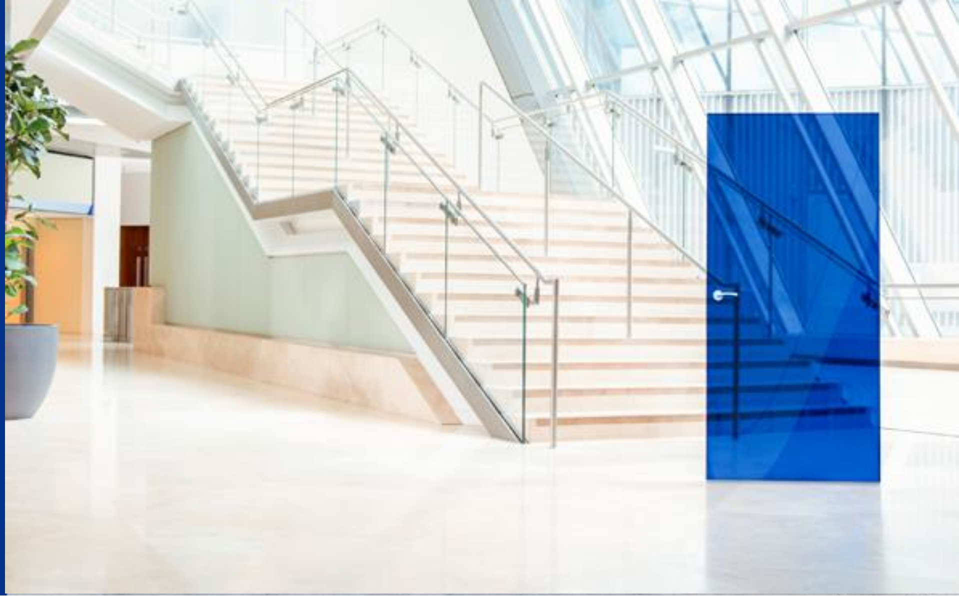
A Conversation with Sir Jon Thompson

KPMG Board Leadership Centre



Sir Jon Thompson, chief executive of the Financial Reporting Council, kindly addressed a meeting of our FTSE100 audit committee chairs group to discuss UK corporate governance and audit reform, the business imperative of ESG reporting, and what boards need to get on top of ahead of the next corporate reporting cycle. A summary of the conversation is set out below.

Governance and audit reform

Restoring trust in audit and corporate governance is a BEIS Whitepaper pulling together the recommendations made in three independent reviews – The CMA review of the statutory audit market, Sir John Kingman's review of the Financial Reporting Council, and Sir Donald Brydon's review into the quality and effectiveness of audit. The consultation has concluded and the Government's response is expected early in the new year. Many of the reforms, which centre on increased transparency, assurance and accountability, go to the heart of the duties of the board.

Investors are calling for better corporate reporting. They want greater disclosure on not just current risks, but longer-term risks too. They want clear and consistent metrics by which to assess a company's impact on the climate and the environment. And they want clarity on how auditors assess key accounting judgments, and their aggressiveness, or otherwise, relative to the sector in which the company operates.

In response, Sir Jon notes that the Government is likely to approve several reforms to rebuild investor confidence in big businesses. He anticipates:

— Stronger supervision of corporate reporting by the regulator and new powers to direct changes to company reports and accounts.

— The introduction of resilience statements looking at resilience in the short, mid and long-term. Regulators will be empowered to work with companies to determine what good looks like.

— Further clarity on the disclosure of distributable profits, but probably not as far as some investors were pushing, nor as far as Brydon recommended.

— A requirement for companies to provide more robust reporting around their procedures for preventing and detecting material fraud.

— More reporting requirements in relation to climate change and the environment.

However, it is unlikely that the Government will take forward the recommendation on providing the FRC access to legally privileged info.

Assurance reforms

The whitepaper elicited significant support for several assurance reforms, particularly changes to the regulatory oversight of audit committees, minimum standards for audit committees and the introduction of audit and assurance statements. These, say Sir Jon, are likely to be adopted into the government's published proposition.

He comments: "Some audit committee chairs are already evaluating their levels of assurance and are thinking about lines of defence. If you haven't done so already, then I recommend that you do, as the government will require you to set out your approach in the new audit and assurance statement."

External audit

Improvements in audit quality are evident over the last financial year, with firms making investments in people, technology and methodologies. However, to further raise the bar on audit quality and, therefore, maintain trust and confidence in the UK financial markets, Sir Jon expects:

— Strengthening of regulatory oversight over audit firms.

— Legislative backing for operational separation of audit from other parts of the firms.

— Increased fraud obligations for auditors.

Measures to open up the audit market look set to proceed with managed shared audits getting the go ahead and, in time, a potential cap on the market share of the Big 4 firms. However, there will be an obligation on the regulator to set out how this might be implemented over a yet to be determined period.

Some guests noted their experience of challenger firms turning down opportunities to pitch for both audit and non-audit work, citing lack of sector experience, the quality of the team and the time available to deliver (say) a meaningful internal audit.

Widening the definition of a public interest entity

The subject of much speculation, Sir Jon reminded guests that the government is revisiting its definition of a public-interest entity. He expects around 1,100 additional businesses to fall within its scope.

"The thinking here is to even out the regulatory burden between being publicly listed and large private companies," explains Sir Jon. Large charities, government entities and limited liability partnerships will be included within the new definition.

Internal controls over financial reporting

Sir Jon noted that there had been considerable feedback relating to the assessed costs of introducing a stronger framework for reporting on internal controls over financial reporting – and, if anything, the initial estimates were too low by a considerable margin.

Ministers are carefully considering the assessed cost against the benefits of this reform. Sir Jon went on to say that "this proposal – one that some have commentated is the most significant of the whole reform package – is likely to be dropped". However, importantly he went on to note that even if primary legislation is not passed in this area, the regulator can raise the bar with revisions to the UK Corporate Governance Code or through including reporting on internal controls in any new minimum standards for audit committees.

More climate action and reporting

On the environment and climate change, Sir Jon said that companies could do much more. Across the market, corporate reporting on the climate is inconsistent, with a notable lack of clarity on how progress towards goals will be achieved, monitored and assured.

For accounting periods ending on or after 1 January 2021, companies with a premium listing on the main market must include a statement in their annual reports to explain their compliance against the Task Force on Climate-related Financial Disclosures (TCFD). Consultation is underway to extend the same disclosure requirements to public-interest entities, including large private companies and some financial services companies.

The direction of travel on climate was reinforced by Chancellor Rishi Sunak at COP 26 in November 2021. He committed to transform the UK into the world's first net-zero finance centre. Although subject to consultation, the intention is that UK financial institutions and listed companies will publish net-zero transition plans. They will be backed by evidence on how they will adapt and decarbonise as the UK shifts towards a net-zero economy by 2050.

Bar rises on corporate reporting

While the quality of corporate reporting has remained reasonably robust despite the COVID-19 pandemic, Sir Jon identified three areas where there is room for improvement:

- Accounting judgements and estimates – a top priority for investors and a top issue for audit quality.
- Disclosure of revenue recognition – now the number two concern for the regulator. "It didn't figure in the top 10 three years ago."
- Cash flow – the most common source of material errors. "Unbelievably, 30 percent of cash flow statements just don't add up."

The Government are expected to respond to the BEIS Whitepaper in early 2022. This will determine which matters make it into primary or secondary legislation, and those that will progress no further. Also, it will define the statutory powers afforded to the new audit regulator, the Audit, Reporting and Governance Authority (ARGA).

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