FRC

Financial Reporting Council

Effective Company Stewardship

Next Steps

September 2011

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One - Introduction

Following the financial crisis in 2007 and 2008, there has been a wide ranging and high profile debate about the effectiveness of corporate governance, financial reporting and audit, both in the UK and elsewhere.

At the heart of this debate lies the manner in which companies assess, manage and report risk and the importance of annual reports that enable investors and other stakeholders to determine whether a company can create and sustain value over the short, medium and/or long term.

Many users of corporate and financial reports, including regulators, investors, politicians and other commentators have criticised the way that companies, particularly those in the financial sector, provided key information and sensitivities in their annual reports in the run up to the financial crisis. As a result, the Financial Reporting Council (FRC) has considered whether, and if so how, companies could improve the way they report to their shareholders. That led to the publication, in January 2011, of a discussion paper entitled *Effective Company Stewardship - Enhancing Corporate Reporting and Audit*[1].

In addition, over the past year, the FRC has examined the audits of a number of financial institutions, has looked into the ways companies manage and report risk and has reviewed the implications of the provision of non-audit services by auditors to the companies they audit. It is now conducting an enquiry into whether the way in which "going concern" judgements are made remains appropriate. Much of this work has contributed to the judgements reached in this paper.

The FRC has not been alone in examining these issues. The European Commission issued Green Papers on Corporate Governance and Audit[2] [3]. The Government issued a consultation paper on The Future of Narrative Reporting[4]. The Treasury Select Committee and the House of Lords Economics Affairs Committee have both made recommendations. More recently, both the US Public Company Auditing Oversight Board ('PCAOB') and the International Auditing and Assurance Standards Board (IAASB) have published papers discussing possible

[1] http://www.frc.org.uk/images/uploaded/documents/Effective%20Company%20Stewardship%20Final2.pdf
[2] http://ec.europa.eu/internal_market/company/docs/modern/com2011-164_en.pdf
[3] http://ec.europa.eu/internal_market/consultations/docs/2010/audit/green_paper_audit_en.pdf
[4] http://www.bis.gov.uk/assets/biscore/business-law/docs/n/10-1057-future-narrative-reporting-consultation.pdf

changes to the way auditors report on audited financial statements.[5] [6] This paper takes account of these initiatives.

The FRC is most appreciative of the 100+ responses received from a wide range of market participants and interested parties. This paper provides feedback on the responses that the FRC has received in response to its consultation, together with the steps that it now proposes to take (with others where appropriate).

Core Principles

Notwithstanding that the various consultations referred to above are wide-ranging, there is one issue that is common to all – namely that audit is not meeting user and/or public expectations and that there is a need for greater transparency about the judgements made by management and auditors in the course of preparing and auditing financial statements.

However, despite largely agreeing on the information that users are seeking, those consultations differ over the route by which it is to be provided. The European Commission and the PCAOB both discuss the provision of such information directly by the auditors, whether through an expanded audit report or through a separate statement, whereas the FRC has advocated the provision of such information through a report by the audit committee.

Respondents were substantially supportive of the FRC's proposals generally and the FRC continues to believe that the approach outlined in its Discussion Paper is correct. There are four principal reasons why it has reached this conclusion:

- It is the company that is responsible for preparing the annual report and the financial statements. It is the company's views that are wanted by, and should be reported to, investors and other users. Therefore, the company, through its board of directors and management, should provide the information - not the auditors;
- The company is best placed to know what users of annual reports and financial statements are interested in – because it is the board of directors and management that have direct contact with investors, analysts and other users of the annual report and the financial statements. Auditors do not have equivalent access to such users;
- If the company provides the information, the risk of auditors making judgements that are properly those of management is avoided; and
- The risk of yet more boilerplate is materially reduced. A report by an audit committee is more likely to be specific to the business than if it is provided by the company's auditor. If auditors are required to provide the information, there is a real risk of standardised language to avoid the possibility of users reading unwarranted

[5] http://www.auditconduct.com/2011/06/pcaob-concept-release-on-the-auditors-reporting-model-comments-due-93011.html
[6] http://press.ifac.org/news/2011/05/iaasb-seeks-global-views-on-enhancing-the-value-of-auditor-reporting

inferences into differences in language[7] between reports by the same auditor on different companies.

The FRC has, therefore, concluded that the better course is for audit committees to provide the information that investors and other users are seeking and the proposals in this paper are based on this approach.

There are three other principles that have guided the FRC's approach when developing the proposals in this paper:

- Preparers, audit committees and auditors must ensure that all material issues are reported in a manner that is complete, neutral, free from error, fair and balanced.
- Auditors must exercise professional judgement when undertaking audits – adopting a challenging (or appropriately sceptical) approach to key issues, assumptions and evidence.
- Both the company and its auditor must be satisfied that the annual report (comprising the narrative report and the financial statements), taken as a whole, is fair and balanced.

It is important to emphasise that, although the proposals in this paper ask for greater transparency on some issues, the FRC does not believe that those proposals should translate into more information in total. The FRC's aim is to improve the quality of narrative reporting - and in the process, it believes that there will be scope to discard some information that is currently provided or publish it in a different way (such as through a company's website).

The UK approach to corporate governance is based on investors discharging their responsibilities as owners of a company, in particular by taking an interest and exercising their rights as shareholders in relation to how a company is managed. The Stewardship Code issued by the FRC in July 2010[8] is designed to support this approach and the FRC believes that the proposals in this paper should provide important information to investors and, by doing so, reinforce the effectiveness of this stewardship model.

[7] There is anecdotal evidence that audit firms would wish to review all reports centrally.
[8] http://www.frc.org.uk/images/uploaded/documents/UK%20Stewardship%20Code%20July%2020103.pdf

Summary of Action

This document outlines the responses the FRC has received to the recommendations in *Effective Company Stewardship* and, following consideration of these responses, it summarises the actions the FRC intends to take.

Narrative Reporting

1. The FRC will work with the Department for Business, Innovation and Skills to support implementation of the Government's proposals on narrative reporting due to be published in the autumn.
2. The FRC will further develop the concept of, and model for, reporting standards to test further whether there is sufficient support for the development of narrative reporting standards, on a comply or explain basis where appropriate.
3. The FRC has established a steering group to help develop the concept of a Financial Reporting Laboratory. It is scheduled for launch in October 2011.

Strategy, Risk and Going Concern

1. The FRC believes that, in future, narrative reports should focus primarily on strategic risks rather than operational risks and those risks that arise naturally and without action by the company; and disclose the risks inherent in their business model and their strategy for implementing that business model).
2. The FRC has established an enquiry under the chairmanship of Lord Sharman of Redlynch to identify whether there are lessons to be learned by companies and auditors addressing going concern and liquidity risks.
3. The FRC intends to update the Turnbull guidance to reflect the lessons from its work on risk, and will also consider whether changes should be made to the UK Corporate Governance Code as a result of that work and the Sharman Enquiry.
4. The review of the Turnbull Guidance will not be a root and branch revision – rather it will be developed to reflect improvements in practice and to clarify the board's responsibility for determining the nature and extent of the significant risks it is willing to take.

The Role of the Audit Committee

1. The FRC proposes that the audit committee should report to the whole board and, after that report has been accepted by the whole board of directors, it should be published in full in the company's annual report.
2. The FRC proposes to develop and consult on revisions to the UK Corporate Governance Code and related Guidance for Audit Committees with the aim of

extending the remit of the audit committee to include consideration of the whole annual report, including the narrative report, to determine whether the information provided is necessary for stakeholders to assess the performance and prospects of the company and whether the report, viewed as a whole, is fair and balanced.

3. A key aim of these changes is to enable effective interaction to take place between investors and companies – a key contributor to making the UK's 'comply or explain' approach to corporate governance effective.

Audit and the Role of Auditors

1. The FRC believes that more needs to be done to demonstrate that auditors are achieving the fundamental purpose of an audit – namely to carry out an independent check into whether a company's financial statements, including the decisions, judgements and estimates involved, have been properly prepared and are fair and balanced.
2. The FRC believes that auditors can and should provide increased insight into the audit process so as to reassure users of financial statements that all material matters have been properly disclosed.
3. To address the need for the contribution by auditors to be more transparent, the FRC proposes to review and consult on revisions to the auditing standards governing reporting by auditors to audit committees (ISA (UK & Ireland) 260) and audit reports (ISA (UK & Ireland) 700).

Other Aspects of the Audit Market

1. To address concerns relating to the length of time that some companies retain the same audit firm the FRC intends to consult on proposals to amend the UK Corporate Governance Code to require companies to put their audits out to tender at least once in every 10 years, or explain why they have not done so; and to require companies to publish an explanation in the annual report of the steps they took when deciding whether or not to put the audit out to tender and their reasons for proceeding in the way they did.
2. The FRC's generally preferred approach is to avoid amending the UK Corporate Governance Code on a piecemeal basis and, so far as possible, it aims to co-ordinate the implementation of the proposals in this Paper with any that may arise from other initiatives currently under consideration unless there is an overriding case made for earlier action.

Two – Narrative Reporting

The content and quality of narrative reporting in annual reports has been the subject of discussion over a number of years. These discussions have resulted in initiatives such as the Operating and Financial Review and its replacement, the Business Review.

Following the financial crisis, there has been a growing recognition that narrative reporting has not received the same focus as financial reporting and this has led to calls for a new, holistic approach where the report provides a concise overview of a business, its strategic objectives, the challenges that it faces and any other information that stakeholders need to enable them to make an informed assessment of a business's ability to create and sustain value.

In August 2010, the Department for Business, Innovation and Skills ('BIS') issued a Consultation Paper - "The Future of Narrative Reporting" - as part of its commitment to reinstate an Operating and Financial Review and to investigate ways of "improving corporate accountability and transparency".

That consultation closed in December 2010. BIS has reported on the responses that it received, and plans to publish a White Paper in early Autumn containing its detailed recommendations. It has already said that it will adopt a principles-based approach which requires companies to produce narrative reports that:

- set out a company's business model, its strategy and the challenges that it faces in achieving that strategy; and
- describe the company's operations, its performance and its management.

The FRC's Proposals

In its Consultation Paper, the FRC proposed that:

- The annual report should communicate high quality and relevant narrative and financial information.
- Directors should take collective responsibility for ensuring that an annual report, viewed as a whole, provides a fair and balanced report on their stewardship of the business.
- Directors should describe in more detail the steps that they take to ensure:
  - the reliability of the information on which the management of a company, and therefore the directors' stewardship, is based; and
  - transparency about the activities of the business and any associated risks.
- Companies should take advantage of technological developments to increase the accessibility of the annual report and its components.

Reactions to the FRC's proposals

Respondents from all constituencies – companies, audit committees, investors both institutional and private, and the accounting profession – supported the FRC’s assessment that there is a need to improve the quality and relevance of narrative reporting.

However, respondents emphasised that any changes should reduce, and not increase, boilerplate disclosures. In their view, the emphasis should be on quality narrative reporting. That would not necessarily be achieved by longer reports – on the contrary they should be focused, concise and relevant.

Respondents from all groups supported a “comply or explain” approach rather than mandatory standards.

The FRC received a significant number of responses to its *Effective Company Stewardship* consultation from private investors. There was widespread opposition to the proposal that companies should post their annual report and accounts on their websites, rather than produce them in print. Some private investors claimed that they already experience difficulties in obtaining hard copy reports from registrars, despite companies being obliged to provide them on request. Particular concerns were raised that the removal of hard copy reports would disadvantage small shareholders, many of whom are elderly and/or have limited access to the internet. Many small shareholders pointed out that they find it easier to read and annotate a hard copy report and to compare it against others.

Opposition to this proposal was not confined to private investors. Stakeholders from other groups expressed concern that online only information could be altered after publication and considered that hard copy reports provide an important safeguard against such behaviour.

The FRC has taken note of these views and does not intend to change the way that companies publish their annual reports. However it still believes that companies should give careful consideration to the ways in which technology can improve accessibility to annual reports.

The FRC received a range of views on whether it should develop narrative reporting standards. The idea of introducing standards received support in the consultations, but there is not yet a consensus on the need to introduce them or what they should look like. Standards help to promote best practice, but if too prescriptive they also stifle innovation. Once generally accepted, they would provide a basis for more extensive review of the narrative report by the Financial Reporting Review Panel, but unless the standard is carefully prepared there is a danger that companies might take a more legalistic approach to reporting.

The consultation showed strong support for the creation of a Financial Reporting Laboratory in which companies could discuss and trial new approaches to reporting with regulators and investors.

Next steps

The FRC will work with BIS to help implement its further proposals and will consider whether further action is required by the FRC to implement the proposals on which it consulted (see page 6). If so, any proposed actions will be subject to further consultation.

The FRC will develop the concept of, and model for, reporting standards to test further whether there is sufficient support for the development of a narrative reporting standard which would apply on a comply or explain basis where appropriate.

The FRC has established a steering group to help develop the Financial Reporting Laboratory. This includes senior government, regulatory, investor, company and audit representations. The Laboratory will be launched on 14 October.

Three – Strategy, Risk and Going Concern

A universal reaction to the 2007/2008 financial crisis has been to question the way in which companies assess, manage and report risk.

These concerns led to the establishment of an enquiry focusing on the financial services sector led by Sir David Walker. That enquiry resulted in a number of recommendations, including that financial services companies should establish separate risk committees. This proposal was supported by the House of Lords Economic Affairs Committee. However, the Committee did not think that the same approach would be appropriate for listed and public interest companies generally.

Separately, the FRC amended the UK Corporate Governance Code in May 2010 to clarify board responsibilities for risk.

Reactions to FRC Views

Although the problems encountered in the financial sector had not pervaded the corporate sector generally, the FRC recognised that the challenges of assessing and managing risk are not limited to the financial sector.

- It has held discussions with representatives of listed companies, investors, accountants and others, to consider how the revised Code requirements have been implemented, identify emerging best practice in the ways in which companies assess, manage and report risk and consider whether 'Internal Control: Guidance for Directors' ("the Turnbull guidance") should be amended.
- It has also asked Lord Sharman of Redlynch to identify whether there are lessons to be learned by companies and auditors addressing going concern and liquidity risks. Lord Sharman's Panel is still taking evidence and is expected to publish its preliminary recommendations in the autumn.

The discussions with companies and investors are reported in a separate feedback paper published today entitled *Boards and Risk.* These discussions confirmed that there is now greater awareness of, and discussion about, risk at board level. However, there was less certainty about whether this greater awareness and time commitment had led to widespread improvements in practice.

Because companies and the risks they face vary enormously, there were differing views as to whether it is either necessary or possible for a board to apply a single, aggregate definition of its appetite for risk as a whole. Some participants felt that all that could realistically be expected of the board is to have a clear understanding of the company's exposure to risk, and how this might change as a result of changes in the strategy and operating environment. When developing the strategy, however, it is important for boards to agree their appetite or tolerance for individual, key risks. A number of participants also emphasised the importance of ensuring that flexible crisis management and disaster recovery systems were in place alongside control systems.

Reporting on the company's risk appetite was felt to be difficult, even if it could be defined, as risk appetite is not constant but varies depending on market conditions. The same could be said about reporting on the company's exposure to risk.

However, those consulted recognised that there is a need to find ways of conveying more useful information. Suggestions for improved reporting included:

- integrating commentary on risk throughout the report, rather than treating it in a stand-alone section;
- specifically, linking reporting on risk to discussion about strategy and the business model;
- explaining changes in the company's exposure to risk over the previous twelve months, as a result of changes in the strategy or business environment, and indicating if it might change in the future; and
- disclosing how key risks were being mitigated.

The FRC's proposals

Having reflected on the points made in the course of the discussions summarised above and consultation responses, the FRC has concluded that in future narrative reports, companies should:

- focus primarily on strategic risks - rather than those risks that arise naturally and without action by the company (such as volcanic interruptions of air travel or earthquake damage); and
- disclose these risks and the major operational risks inherent in their business model and their strategy for implementing that business model, explaining how they will address those risks and any obstacles that may be encountered as a result of changes in the business environment.

The FRC considers this would be more consistent with directors' legal duty to focus on the principal risks and uncertainties facing the company, rather than producing indiscriminate lists of all the risks companies face.

The FRC believes that any description of the risks a company faces should not be made difficult to assess by being scattered about the annual report. Consequently, if a company considers that the risks it faces are best understood if discussed in the context of the company's strategy, those risks should also be included in the company's description of principle risks in the Business Review (section 417, Companies Act 2006).

Next steps

The FRC intends to update the Turnbull Guidance to reflect the lessons from its work on risk, and will also consider whether changes should be made to the UK Corporate Governance Code as a result of that work and the Sharman Enquiry.

The review of the Turnbull Guidance will not be a root and branch revision. The intention is rather that the guidance should be developed to reflect improvements in practice and to clarify the board's responsibility for determining the nature and extent of the significant risks it is willing to take.

Four – The Role of the Audit Committee

The role of audit committees is to oversee, on behalf of the whole board of directors, the integrity of a company's financial affairs (from the effectiveness of its internal control regime to the fair presentation of a company's financial position in its annual report). It is also responsible for assessing the effectiveness of the external auditors and for making recommendations on the external auditors to be appointed for the coming year. The audit committee's role is a key element of the corporate governance structure in the United Kingdom and is of increasing importance.

However, much of the work that audit committees do is invisible to investors and other users of financial statements and, as a result, the valuable work they do goes unseen and unappreciated, and a key opportunity to build confidence in financial reporting is missed. As transparency encourages best practice, the limited nature of the reports also reduces the ability of committees to learn of and adopt successful approaches developed elsewhere.

The FRC's proposals

In its discussion paper, *Effective Company Stewardship*, the FRC sought to address these missed opportunities.

It proposed that annual reports should include a report by audit committees setting out the approach that they have taken to the discharge of their responsibilities, describing in such terms as they consider appropriate, and having regard to the commercial interests of the company concerned:

- the key sensitivities, including the choice of accounting policies, that they identified to the integrity of the annual report, including the financial statements, and how they arranged for those to be addressed;
- any matters of material significance identified by the audit committee that are not addressed elsewhere in the annual report and which, in the directors' view, should be known to users if the annual report, taken as a whole, is to be fair and balanced;
- the steps they took and the judgements they made to assess the effectiveness of the audit;
- the policies that they adopted to avoid the independence of the company's auditors being compromised through the provision of non-audit services;
- the process by which they reached their recommendation to appoint or reappoint (as the case may be) the company's external auditors and the reasons for that recommendation; and

- the reasons for any dialogue that they may have had with investors in relation to any material audit issues (not addressed elsewhere in their report).

In its report, the House of Lords Economic Affairs Committee advocated greater transparency in relation to the appointment (or reappointment) of external auditors and increased dialogue between audit committees and a company's principal shareholders. These recommendations mirrored to a large extent the proposals in *Effective Company Stewardship*.

The European Commission's Green Paper did not focus on the role of the audit committee, but it did support regular dialogue between the auditor, the audit committee and the internal auditor.

Reactions to FRC Proposals

There was broad support from the audit profession and institutional investors for the principle of a greater audit committee role. Some respondents from listed companies were concerned:

- at the suggestion that it was the role of the audit committee to hold management to account; and
- that a significant increase in audit committee responsibilities would make it difficult to find suitable people willing to take on the role.

An important concern identified by many respondents, including those in favour of a greater role for the audit committee, was that the proposals threatened to undermine the concept of a unitary Board. They commented that it would be better for any expanded audit committee report to come from the Board as a whole.

The FRC's proposals on audit committee reports were also discussed in the course of the FRC's meetings on risk (see Chapter III). There was some concern that the proposals might increase the length of the report without a corresponding increase in value; some participants thought that audit committee reports that dealt with the main issues discussed by the committee, rather than process, would provide reassurance that the audit committee was operating effectively and properly discharging its responsibilities.

Next steps

Having reflected upon the responses that it has received, the FRC proposes to revise aspects of its proposals in order to address the concerns of respondents that those proposals would undermine the concept of the unitary board.

Its proposals will, therefore, be amended to provide that the audit committee should report to the whole board and, after that report has been accepted by the whole board of directors, it should be published in full in the company's annual report.

Subject to that variation to its proposals, the FRC proposes to develop and consult on revisions to the UK Corporate Governance Code and the related Guidance for Audit Committees which would apply to FTSE 350 companies.

The proposed revisions will seek to achieve the following objectives:

- The extension of the remit of an audit committee to include consideration of the whole annual report, including the narrative report, with a view to determining whether:
    - it provides the information necessary for stakeholders to assess the performance and prospects of the company.
    - the annual report, viewed as a whole, is fair and balanced.
- A requirement that the audit committee reports to the full board of directors setting out:
    - the issues that they considered in relation to the financial statements and how these issues were addressed, including any key judgements that they made;
    - the basis for its conclusion that the annual report, viewed as a whole, is fair and balanced including any matters relevant to that conclusion that are not addressed elsewhere; and
    - an assessment of the effectiveness of the external audit and the approach taken to the appointment or reappointment of the external auditor (see Chapter Six).
- Publication of the full audit committee report in the company's annual report.

Investors have an important role to play in ensuring that the UK's "comply and explain" approach to corporate governance is effective. By providing a report on the key issues that have arisen in developing the financial statements and on other matters relevant to investors' assessment of the company's prospects, the FRC believes that the proposed audit committee report will make a major contribution to enabling effective interaction to take place between investors and companies.

However, to be fully successful, the proposals must not stimulate the production of more boilerplate text. This is pernicious in the way it obscures what investors need to know. Those who put such text before boards no doubt seek to limit the company’s liability, but in doing so they also reduce transparency in the boardroom. Drafts of directors’ reports should be a stimulus to a real debate by boards on whether all relevant matters have been appropriately addressed. Verbiage that glosses over the realities only increases the risks that issues will fail to be debated properly. Those who seek to reduce risk in this way therefore achieve the opposite of their objectives.

The FRC recognises that over-prescriptive reporting requirements can encourage boilerplate. Any proposals to amend the Code and guidance will be cast in terms of the objectives to be achieved, rather than the detail of how it is to be done and, where appropriate, will be 'tested' through the new Financial Reporting Laboratory. The FRC believes such an approach provides the best prospect of ensuring that audit committee reports are meaningful and individual to the companies concerned.

Five – Audit and the Role of Audit

There has long been a general recognition that the audit process is opaque, that the pro forma audit report is wholly uninformative about the matters that interest shareholders and users of financial statements and that this undermines confidence in the value of the audit process.

As a result, stakeholders, and in particular investors, have called for greater transparency about the key issues that arose in the course of the audit, how they were addressed and any other matters bearing on whether the financial statements give a true and fair view.

The FRC's proposals

When the FRC considered this issue, it was immediately clear that one approach might be to redesign the audit report so that auditors provided, in their own words, a commentary on the financial statements, any issues that had arisen, how they had been resolved and, ultimately, whether those financial statements gave a true and fair view.

The FRC rejected this approach. It believes that the responsibility for communicating key information to shareholders lies with a company's directors and executive management. The role of an auditor is to review a company's annual report, including its financial statements and provide a "second" opinion on whether they have been properly prepared. The FRC is keen to avoid a reporting structure that undermines directors' and management's responsibility for providing key information. It does not believe, therefore, that auditors should be placed in a position where they might be required to perform a management role.

For these reasons, the FRC is proposing that the audit committee (and not the auditor) should be responsible for providing any necessary additional information (see Chapter Four above).

That said, the FRC does believe that there are areas where auditors can make a valuable and important contribution. The FRC, therefore, proposed that:

- The standards governing the provision of reports by auditors to audit committees (such as ISA (UK & Ireland) 260) should be revised to ensure that auditors are required to provide audit committees with the information that they need to understand fully the factors that the auditors relied upon in exercising their professional judgement in the course of the audit and, in particular, in reaching their audit opinion. Those are likely to include, at a minimum, the auditor's views on:

    - the effectiveness of the company's system of control (including their assessment of any undisclosed matters arising from the company's business model);

- the judgements made in the audit plan about what is of material significance and the implications of those judgements for the level of assurance provided by the audit;
- the appropriateness of the accounting policies (viewed individually and in aggregate);
- their overall conclusions on the valuations of the company's assets and liabilities provided by management (with particular reference to those that are significant to the financial statements); and
- any other matters identified in the audit plan or by the audit committee as material to the proper presentation of the company's financial position.

- Auditors should provide an expanded audit report that includes

    - a new section that addresses the completeness and reasonableness of the audit committee's report; and
    - identification of any matters in the annual report that the auditors believe are incorrect or inconsistent with the information contained in the financial statements or obtained in the course of their audit.

The House of Lords Economic Affairs Committee did not address the content of the audit report. It focused on the importance of professional scepticism, in particular the question of whether auditors were adequately sceptical in the run up to the financial crisis.[9]

In its Green Paper, the European Commission took a different approach. It asked respondents to consider a range of possible alternatives. These included whether:

- auditors should provide a higher level of assurance to shareholders than at present;
- auditors should take additional steps to verify balance sheet line items;
- the binary nature of the audit report should be revisited;
- auditors should disclose the components of the financial statements that they had actually audited, those in respect of which they had relied upon management assurances and those that had been reviewed by a company's internal audit function;
- auditors should disclose information on a company’s exposure to future risks or events;

[9] This area is the subject of a separate initiative by the Auditing Practices Board ('APB'). The APB, which is part of the FRC, is developing guidance on the meaning and essential characteristics of professional scepticism and is considering revisions to the standards governing the management of audit practices to ensure that professional scepticism is promoted and developed. Auditor scepticism continues to be a focus of Audit Inspection Unit monitoring.

- there should be a shorter period between the year end and the issue of the audit opinion;
- auditors might have a role to play in providing assurance on corporate, social and environmental responsibility; and
- in the case of public interest companies, auditors should report on future events that could affect the company's performance.

The European Commission also stressed the need for auditors to display appropriate professional scepticism.

Responses to the FRC's proposals

Respondents' views were mixed. Some argued that auditors should already be taking the steps proposed by the FRC. Others, including institutional investors and many of those within the accountancy profession, were supportive of the FRC's proposals. Listed companies were less positive about the proposals, largely because of concerns about likely audit fee increases. Others were concerned at the "circularity" in the system that would arise from the requirement for auditors to review the report of the audit committee which is supposed to be overseeing their work.

A few respondents argued that auditors should already be identifying incorrect or inconsistent matters in the annual report and queried the need for a new requirement in this area.

Next steps

The FRC believes that more needs to be done to demonstrate that auditors are achieving the fundamental purpose of an audit – namely to carry out an independent check into whether a company's financial statements, including the decisions, judgements and estimates involved, have been properly prepared and its annual report is fair and balanced.

To achieve this, auditors can and should provide increased insight into the audit process and reassure users of financial statements that issues which are material to the financial statements have been properly disclosed. For the reasons described in Chapter IV, the FRC believes that the primary responsibility for providing this information rests with the company – hence the proposal that audit committees should produce reports fully describing those important judgements and other matters addressed in the course of the audit.

To address the need for the contribution by auditors to be more transparent, the FRC proposes to review and consult on revisions to the auditing standards governing:

- reporting by auditors to audit committees (ISA (UK & Ireland) 260). Such revisions will be intended to give effect to the reporting obligations outlined on pages 16 and 17[10]; and
- audit reports (ISA (UK & Ireland) 700). The revisions to ISA (UK & Ireland) 700 will be intended to give greater transparency to the work carried out by auditors in relation to the annual report as a whole. Those revisions will require auditors to report whether the review they undertake of the annual report under ISA (UK & Ireland) 720 has revealed any information which is incorrect or inconsistent with the information contained in the financial statements or obtained in the course of their audit. The effect of the revision to ISA (UK & Ireland) 700 would be to require auditors to report their conclusion in every audit report rather than, as at present, only when they encounter information that is inconsistent with the information contained in the financial statements.

These revisions would not affect the underlying work undertaken by auditors under existing auditing standards – only its transparency.

[10] The FRC's Professional Oversight Board has been reviewing the quality of reporting by auditors to FTSE 100 audit committees and this work will inform the development of any proposals for revising ISA (UK & Ireland) 260 and guidance on best practice

Five – Other Aspects of the Audit Market

Three other aspects of the audit market have been the subject of debate.

- the structure of the audit market
- the length of time that some companies have their financial statements audited by the same audit firms
- the circumstances in which it is (or is not) appropriate for auditors to provide non-audit services to the companies they audit.

It is noteworthy that the FRC, the House of Lords Economic Affairs Committee and the European Commission have all raised these areas as of fundamental concern. The House of Lords Economic Affairs Committee called on the competition authorities to investigate the position and intervene as appropriate. The European Commission has consulted on steps that would involve regulatory intervention in the operation of the market with a view to engineering structural change.

In the FRC's view, regulatory intervention is generally not the appropriate means by which to address a competition and market structure issue. The competition authorities have powers to address such issues and the FRC welcomes the Office of Fair Trading's consideration of this issue and notes its preliminary decision, announced in July, to refer the audit market to the Competition Commission. It will assist the OFT, and other competition authorities, in its work as necessary.

The second area of concern has been the length of the relationship between certain companies and their auditors. Some have lasted for over half a century and that necessarily calls into question the nature of the relationship and the degree of institutional (if not personal) familiarity that has developed.

The third area of debate has been the extent to which it is appropriate for companies to ask their auditors to provide non-audit services. This is based on a concern that auditor independence is jeopardised by the extent and importance of such non-audit services.

The FRC's proposals

The audit appointment process

The European Commission has expressed concerns about the length of time some companies have appointed the same firm to audit their financial statements – those concerns being based on institutional familiarity.

Although the FRC has not consulted previously on proposals to address the duration of audit appointments, it has consulted on ways in which investor involvement in the audit appointment process could be increased. Suggestions included direct discussion between a company's audit committee and a group of principal investors and a requirement that audit committees should specifically report on the reasons why they had decided to appoint or reappoint (as the case may be) the company's auditors.

Non-audit services

Both the House of Lords Economic Affairs Committee and the European Commission have raised concerns about the provision by auditors of non-audit services to the companies they audit.

The FRC, in response to a recommendation by the House of Commons Treasury Select Committee, undertook an extensive consultation into whether auditors should be prohibited from providing non-audit services to the companies that they audit. That consultation produced an overwhelming response – from all categories of user - in favour of permitting auditors to provide such services.[11]

That said, steps were taken to tighten up the UK standards governing the provision of non-audit services.

- Amendments were made to tighten up the circumstances in which auditors could provide certain services – particularly in relation to where commitment fees may be payable, where conflicts of interest arise and in relation to the provision of tax structuring advice; and
- Audit committees were required to provide greater transparency about the circumstances in which auditors were permitted to provide non-audit services and the fees they earned for doing so.

These proposals only came into effect in December 2010 and so the effect that they have had on the approach that audit committees take has yet to be seen.

[11] http://www.frc.org.uk/images/uploaded/documents/Consultation%20provision%20of%20non-audit%20services%20by%20auditors2.pdf

Reactions to the FRC's proposals

The audit appointment process

The proposals to increase investor involvement in the auditor appointment process via a fuller audit committee report and/or discussions with principal shareholders on the approach to be taken to appointment or re-appointment was probably the most controversial of all the proposals in the *Effective Company Stewardship* paper.

Although there was some support for the proposal from investors and the audit profession, listed companies were universally opposed to the idea. They expressed concerns over confidentiality issues arising from greater disclosure of the appointment process, and it was pointed out that audit committees would find it difficult to explain in an objective and authoritative manner a decision based on "feel" or personalities.

The suggestion that audit committees engage with principal shareholders was seen by many as even more difficult as it would serve to unfairly advantage one group of shareholders over others. Some institutional investors indicated that they did not see the need to be involved in audit appointment decisions but would be supportive of a mechanism where they would be consulted in certain circumstances; for example, where problems had previously arisen with the company's controls or governance.

A few investors expressed frustration at the lack of audit tendering activity. This was balanced by companies and industry groups stressing the costs involved with changing auditors. Listed companies remain opposed to any move towards mandatory auditor rotation.

Non-audit services

The steps taken by the FRC have only recently been put into effect. The FRC is monitoring the position closely and will be keen to establish whether companies and their auditors have responded to those initiatives, particularly in relation to the provision of tax advice.

Next steps

The audit appointment process

The FRC has noted the concerns that respondents have expressed at its proposals to increase investor involvement in the audit appointment process. It does not, therefore, intend to proceed with those proposals.

However, to address concerns about the duration that some companies have the same audit firm, the FRC intends to develop and consult on proposals to amend the UK Corporate Governance Code and the related Guidance for Audit Committees, the effect of which would be to:

- Require companies to put their audits out to tender at least once in every 10 years, or explain why they have not done so. So that there is time to undertake an effective and open tender process, audit committee reports should announce that, absent unexpected developments, the company intends to put its audit to tender in the forthcoming year (rather than announcing it has happened after the event). This approach would have the benefit of enabling investors to be consulted and, therefore, to exercise their stewardship responsibilities; and
- Require audit committees to explain, in their report published in the company's annual report, the steps that they took when deciding whether or not to put the audit out to tender and their reasons for proceeding in the way that they did – for example, why they did or did not go to tender; if they did not, when a tender was last conducted; why they chose to reappoint the existing auditors; or why they appointed new auditors.

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