FINANCIAL REPORTING LAB

Lab project report: Reporting of Audit Committees

October 2013

FRC

Reporting of Audit Committees

Contents

References made in this Report to views of 'companies' and 'investors', refer to the individuals from companies and investment community organisations that participated in this project. The term 'investors' is used as shorthand to refer to the investment community participants in this project, which include a broad range of individuals in their capacity as investors or their role in analyst organisations that work in the interest of investors.

Project summary

Last year, the FRC issued a revised UK Corporate Governance Code (the Code) applicable to companies with a Premium listing of equity shares for financial reporting years beginning on or after 1 October 2012.

The Code calls for the annual report and accounts, taken as a whole, to be fair, balanced and understandable. It also calls for a description of the work of the Audit Committee (AC) to include:

- the significant issues considered in relation to the financial statements, and how they were addressed;
- how the AC assessed the effectiveness of the external audit process; and
- the approach to appointing the auditor and how objectivity and independence are safeguarded relative to non-audit services.

The aim of this Lab project is to provide further insight from companies and investors on effective approaches to AC reporting, including both the content and style of presenting information. This project focused on the three areas noted above, and not on other areas on which ACs often report, for example, matters related to internal controls, the internal audit function or other areas delegated by the board.

Publication of this Report has been timed so that companies can benefit this year from the views of the 19 companies and 26 investors that have taken part in the project. (See the section '*Project process*' for more information.) Many project participants regard the changes to the Code as a turning point in AC reporting, and view the Lab's project as an opportunity to help influence concise AC reporting that better addresses the needs of investors, i.e. without adding clutter.

Some companies, however, are concerned that the disclosure of significant financial statement issues may be taken out of context and potentially misunderstood by investors, and that being transparent may disadvantage them with investors vis-à-vis companies that disclose less. It is hoped that the ideas in this Report will help alleviate these concerns, by assisting companies to provide the sort of concise summaries of useful information, in appropriate context, that will over time become more of the norm.

Views differ on what information content is useful and the way it is best presented, and some investors indicate that their views are still developing. However project participants agree on many aspects of how AC reporting can be improved, and it is these aspects that form the basis of this Report.

The FRC regularly monitors application of the Code by companies. Additionally, the Lab plans to explore with companies and investors whether there is appetite to conduct a follow-up project with the benefit of experience gained in the upcoming annual reporting cycle, including the first enhanced reporting by ACs and auditors.

Further developments in AC reporting will be influenced by the Competition Commission's final decision on remedies for the audit market. These include an advisory shareholders vote on whether the AC's reporting is satisfactory.

What is the Lab?

The Financial Reporting Lab has been set up by the Financial Reporting Council to improve the effectiveness of corporate reporting in the UK. The Lab provides a safe environment for listed companies and investors to explore innovative reporting solutions that better meet their needs.

Lab project reports do not form new reporting requirements. Instead, they summarise observations on practices that investors find useful to their analysis and encourage companies to consider adopting the practices if appropriate in the context of their own reporting. It is the responsibility of each reporting company to ensure compliance with relevant reporting requirements.

Find out more about the Lab including information about other projects at: http://www.frc.org.uk/Our-Work/Codes-Standards/Financial-Reporting-Lab.aspx

A separate AC report

The Code requires the AC to report in a separate section of the annual report and accounts (annual report) how they have discharged their responsibilities in relation to the three topics that are the focus of this Report. While not required, investors consider that AC reporting is best presented by way of a separate AC report, rather than as a section of another report, such as the board's governance report.

A separate AC report, with a personalised introduction by the AC Chair, their picture, name or even signature, all demonstrate accountability and signal ownership, stewardship and transparency. For the same reasons, investors appreciate when AC reporting is written in the first person by the AC chairman. Notwithstanding this, it is recognised that the board as a whole holds the ultimate responsibility for the annual report.

Engagement and communication

The detailed observations described in this Report are structured in three sections which mirror the areas of AC reporting under the Code. Example disclosures from the reports of participating companies are used to illustrate certain of the practices described for each of these topics.

Project participants consider that the changes to AC reporting brought about by the revised Code should promote better engagement and communication between investors and companies, and that high quality reporting which meets investor needs should help to promote long-term commitment from investors.

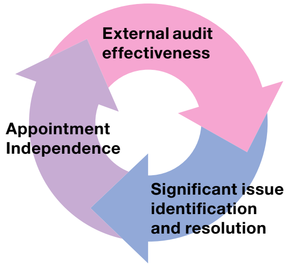
The key to achieving this is telling a specific story about the company, explaining what the AC has done and how, and linking this to the relevant conclusions and financial reporting outcomes, thereby providing a better understanding to investors of how the AC has fulfilled its role.

It is expected that, over time, enhanced communication through AC reporting will lead to more of a conversation between investors and the AC, and improve the understanding of the AC's role and how it fulfils its obligations more generally. Such insight should build over years, as ACs across the market add to the collective knowledge through reporting of their activities.

AC reporting need not be lengthy; few words can convey considerable information. What is said should cover the breadth of a topic, including links to additional information, where appropriate.

While the appetite for information on each of the three areas varies, participants see some interconnectivity between them. If the AC has a thorough and effective process to appoint auditors, including adequate policies and processes to maintain independence, these are seen

Effective corporate reporting



as contributing to an effective external audit process. When combined with an effective AC process to challenge and resolve significant financial reporting issues, this fosters a financial reporting environment in which significant issues are identified, resolved and disclosed transparently.

Investor Views:

"AC reporting should encourage more conversation to build confidence."

"We do not dwell a lot on Audit Committee reports but we would if they had more content."

Company Views:

"We never receive questions from investors on AC reporting."

"We would like to address investors' needs, provided that we better understand what they are looking for."

Key themes for AC Chairs:

- Demonstrate ownership and accountability by personalising your reporting;
- Be specific to your company and to the current year;
- Say what you did (not just what you do): depict the specific activities during the year and their purpose, using active, descriptive language;
- Disclose judgement calls made for the year, and the sources of assurance and other evidence drawn upon to satisfy yourselves of the appropriateness of the conclusion;
- Consider your audience in describing issues and their context, policies, processes, conclusions and their consequences for the company and its reporting; and
- Consider where in the annual report information is best included, and avoid repetition.

Addressing significant financial statement issues generated the most interest and comment from both investors and companies. It is this area that they believe has the most scope for improvement and is considered to have more information content. For example, investors feel it could assist them in developing views on valuation.

Investors identify a sense of urgency for ACs to describe frankly the significant issues, including the difficult judgements and what they have done to address them. Recent changes also require auditors to read the AC's reporting and comment by exception on significant issues if they are not reported on appropriately.

In relation to the other two areas – assessing effectiveness of the external audit process and appointing the auditor and safeguards on non-audit services – investors and companies acknowledge that there is some scope for improvement, but urge that care be taken to keep additional disclosures focused and not add clutter. While some investors express limited interest in these topics, others consider that such disclosures are relevant in contributing to effective corporate reporting and providing insight on this aspect of board behaviour.

Addressing significant financial statement reporting issues

Issues to be disclosed:

- Investors appreciate that companies will need to use judgement to determine whether an issue is significant, taking into consideration what may be useful to a reasonable investor. Companies also commented that the issues on which the AC reports to the board may be a good indication of issues for disclosure.
- If the AC and the auditors have spent significant time dealing with an issue, i.e. it has been the subject of particular focus for the year, this is a strong indication that it is important enough to be disclosed.
- This approach to focusing on what the AC did also recognises that small issues which are likely to become significant, and emerging issues on which the AC has not yet spent a significant amount of effort, may warrant disclosure.

Context of the issue:

- Investors want AC reporting to move away from boilerplate disclosure and to be bespoke and company specific. The description of each significant issue should be tailored to the company and the year.
- Providing context to the issue helps to accomplish this. For example, quantifying the issue, identifying the related business unit, geography, contract or transaction type, describing the nature of the issue as being related to a specific policy or involving a specific assumption or estimate, and stating clearly the outcome, all help communicate the specific story.

What the AC did:

- Investors would like to understand in greater depth how the AC fulfilled its role and the robustness of the steps it undertook to assess each significant issue and reach conclusions.
- Many investors believe that the AC should not place an undue level of reliance on the external auditors or management. They would like to gain an understanding of the key areas of debate and challenge that the AC focused on, and the sources of assurance, for each specific topic.
- Investors prefer the use of more descriptive, 'active' language stated in the past tense, as this provides assurance that the AC has positively taken specific steps to address the issue.
- Where applicable, and not disclosed elsewhere, investors appreciate that the AC mentions ranges or scenarios taken into consideration, key assumptions, and whether reported amounts fall within an acceptable range.

Presentation of disclosure:

- Taking care to ensure information is disclosed in the most appropriate place in the annual report, allows cross referencing to be used to help investors locate the related information quickly, while avoiding repetition.

Investor Views:

"The traditional lack of engagement of the investment community in matters addressed by the AC comes as a result of the lack of 'hooks' to form a discussion around."

"It's not useful to have four pages on immaterial issues – far better to be shorter and focus on real issues."

"The quality and value from AC reports comes from the specifics."

Company Views:

"By implication, we've been looking at things we consider to be significant."

Assessing external audit effectiveness

- Investors expect ACs to report concisely the activities performed, together with the outcome, and to avoid cluttering the annual report with extensive disclosure of policies.
- If the AC reviews inspection reports from independent audit regulators and considers the outcome of internal company surveys on auditor performance, investors encourage ACs to describe these and any resulting actions.

Appointing the auditor and safeguards on non-audit services

- Participants acknowledge that external audit tendering will become part of the normal business cycle and represents good governance.
- Investors appreciate disclosure of the company's policy on tendering, and, in advance, any intention to tender, as this will provide an opportunity to engage in the process.
- Investors prefer that a summary of the company's policies to preserve auditor independence be included in reporting by the AC, though the full policy could be made available on the company's website.
- Investors agree that they would like any change to the company's policy on non-audit services to be disclosed together with the reason for the change.
- Disclosures detailing the nature and amount of the non-audit services – beyond generic classifications – are favoured by investors.
- Investors indicate that it would be useful to have disclosure of non-audit services fees as a percentage of audit fees as this is a clear and measurable outcome.

Investor Views:

"We do not want rhetoric and clutter, we want more meaningful information."

Lab comment

Audit Committee Reports, Global Disclosure Guidelines

In the course of this Lab project, some investors noted that in October 2011, the Enhanced Disclosure Working Group (EDWG) published a report Audit Committee Reports, Global Disclosure Guidelines reflecting investor views on AC reporting.

The scope of the EDWG's report is wider than this project, including guidelines in relation to the AC charter and membership and information flows to the AC, among other areas. To the extent these two projects overlap, common themes and observations include:

- confirming that information received and significant assumptions have been reviewed, analysed, and where appropriate, challenged by the AC with an independent mind-set;
- disclosing non-audit fees and their nature, the external auditor's tenure and the company's policy for tendering;
- providing a non-boilerplate report that gives a useful and engaging account of the company's activities, with emphasis on key audit issues and how they are managed.

Project observations

Background

In addition to revising the Code, the FRC revised the *Guidance on Audit Committees* (the Guidance) which indicates that:

- The AC will need to exercise judgement in deciding which of the issues it considered in relation to the financial statements are significant, but should include at least those matters that have informed the board's assessment of whether the company is a going concern. The AC should aim to describe the significant issues in a concise and understandable form. The statement need not repeat information disclosed elsewhere in the annual report and accounts, but could provide cross-references to that information.
- When reporting on the significant issues, the AC would not be expected to disclose information which, in its opinion, would be prejudicial to the interests of the company (for example, because it related to impending developments or matters in the course of negotiation).

Some boards may also ask their AC to assess whether the annual report and accounts, taken as a whole, is fair, balanced and understandable and provide the information necessary for shareholders to assess the company's performance, business model and strategy. The Guidance indicates that to the extent the AC undertakes tasks on behalf of the board, the results should be reported to, and considered by, the board.

Related changes to auditing standards require auditors to read the AC disclosures and comment by exception on certain matters if not appropriately addressed in the reporting of the AC. Additionally, auditors will be required to report on significant audit matters, such as the application of materiality, their assessments of risks of material misstatements, and how the audit has been responsive to these.

Lab Comment

Reporting by auditors

The FRC updated International Standards on Auditing (UK&I) 260 Communication with those charged with governance and 700 – The independent auditor's report on financial statements to take effect concurrent with the changes to the UK Corporate Governance Code.

The changes are directed at:

- requiring the auditor to communicate to the AC information that the auditor believes that the AC will need to understand the significant professional judgements made in the audit;
- extending auditor reporting by requiring the auditor to report, by exception, if the board's statement that the annual report is fair, balanced and understandable is inconsistent with the knowledge acquired by the auditor in the course of performing the audit, or if the matters disclosed in the report from the AC do not appropriately address matters communicated by the auditor to the AC;
- if the section of the annual report describing the work of the AC does not appropriately disclose matters communicated by the auditor to the AC that in the auditor's judgements should have been disclosed, or if the annual report does not contain such a section, the auditor's report shall also include any such information; and
- requiring auditors to give information, inter alia on significant audit matters. The standard highlights that cross-referencing to the AC report may achieve this and so reduce duplication and clutter.

Risk management, internal controls

Some investors consider that internal control matters may constitute significant issues to be disclosed. Later this year, the FRC plans to issue for consultation an update of its Code guidance to directors on risk management and internal control which deals further with reporting on these matters.

Narrative reporting

To facilitate improved reporting around company strategy and business model, the FRC recently published for consultation Guidance on the Strategic Report. The guidance builds on the changes made to the Code in October 2012, requiring annual reports to be fair, balanced and understandable.

Addressing significant financial statement reporting issues

Only report on significant issues – what's significant?
There is an assumption by investors that the AC will have focused its efforts on the most significant issues for the company; i.e. time spent or at least a significant focus by the AC is a good indicator of significant issues related to the financial statements to be disclosed.

For example, there may have been a significant focus during the year on specific accounting policy decisions, aspects of applying accounting policies, consideration of appropriate disclosure, or ensuring the financial statements give a true and fair view. Additionally, some ACs may have focused on addressing enquiries from regulators, or on the disclosure of non-GAAP measures and KPIs that accompany financial statement information, whether presented in the financial statements or elsewhere.

A minority of investors expressed a view that IFRS measures do not fully meet their information needs. For example, financial asset impairment on an expected loss basis would result in more adequate provisioning than occurs under the current incurred loss approach. Most participants expressing a view on this felt that the main vehicle for disclosure on such issues is likely to be outside of AC reporting, but that if there was a significant focus placed on such non-GAAP measures by the AC, then that aspect of the AC's work would be disclosed.

While participant opinions differ on which topics should be disclosed as significant issues, there is a consensus that, if the AC, management and auditors have spent time dealing with an issue, i.e. it has been the subject of particular focus in the year, this is a strong indication that it is important enough to be disclosed. Companies also commented that the issues on which the AC reports to the board may be a good indication of issues for disclosure.

Explanations of why the AC has considered issues to be significant provides context to the AC's assessment of reporting risk, and reflects the weight of what the AC did in relation to the year. Focusing on these issues and what was done by the AC should provide more colour on the current year's activities and their emphasis, and prevent the disclosure becoming boilerplate.

Some investors commented that it can be helpful for companies to succinctly highlight their on-going financial reporting issues even if they have not been an area of focus for the AC in the particular year (such as an issue that is only looked at once every few years, or an issue for which there is no change within the year). Others thought this would lead to boilerplate disclosures and clutter. It is likely that such on-going issues are included elsewhere in the accounts and can be referred to briefly in the AC report.

Providing context for issues disclosed as significant, for example in relation to a rolling work programme undertaken by the AC, can be helpful, but this could also be explained elsewhere and referred to in the AC's reporting. Separating disclosure into two sections, one relating to fresh information on what was significant in the year and another that is more recurring year on year, can also provide helpful context of the AC's approach to focusing its efforts.

Additionally, while significant time may not yet have been spent on emerging issues, disclosing these as well can be of interest and helpful to investors by pointing in the direction of potential risk and confirming that the AC is identifying and planning to address such issues.

Some investors would rather have more than less information, and would like to know about small issues before they escalate. However, most investors acknowledge that the number of significant issues to appear in the AC report will largely depend on the size and complexity of the company. Investors acknowledge that care should be taken in identifying which issues should be included in the AC report to avoid cluttering the annual report with disclosures which are not relevant to their understanding of the key issues for the company.

Investor Views:
"We will ask about issues we expect if we don't see them disclosed."

"If the audit committee, management and auditors have spent time dealing with an issue that should mean that the issue is significant enough to be disclosed."

Company Views:
"If investors tell us what disclosure they would like, we'll work towards providing it."

"Significant accounting issues are usually recurrent. It will be a challenge to articulate what changes year on year."

Some companies reason that an issue that was dealt with during the year may not be significant by the time the annual report is released. However, investors consider that even if an issue has been resolved to the satisfaction of all the parties, it is important to communicate, not only that the issue has been dealt with, but how it was dealt with, since it will generally have affected the reporting of financial performance in the current year and it could reoccur.

A number of investors also consider that if the AC spends time considering significant internal financial control matters, they should communicate also how they have satisfied themselves that any associated financial reporting risks have been addressed.

Some investors commented that any financial reporting issue, or combination of issues or judgements, that materially affect management compensation should also be disclosed in the AC's reporting as a significant issue.

Most investors indicate that while it is not possible to develop an exact definition of 'significant' as a guide for companies, ACs will need to exercise judgement to determine what may be significant to a reasonable investor. Other participants observed that as auditors will be providing more insight on their approach to materiality in the context of the external audit, it will be interesting to see how any links develop.

Additionally, most recognise that not all issues that are of significance to the audit will have required significant focus or new judgements by the AC during the current period.

Disclosure of significant issues should be specific to the company

There is general agreement among companies and investors that AC reports tend to be boilerplate. Both consider that there is room for improvement by ensuring the reports are more company specific by clarifying details used in describing the significant issues and providing context.

More detailed disclosure need not be lengthy, but should ensure that AC reporting tells a story specific to the company, demonstrating why the issue was felt to be significant through to its consequences for financial reporting.

Investors suggest that ACs quantify the significant issues, particularly when the relevant amounts are not shown elsewhere in the annual accounts. This allows a view to be taken on their relative importance and provides investors with the basis for making their own calculations.

Companies acknowledge that investors require greater transparency than is typically evidenced at present and that greater transparency is a basis for more consistent communication between a company and investors over time, which may even encourage longer term investment. They also expect that such disclosure will become the norm, whereas currently it is still exceptional.

Investors would like ACs to be as transparent as possible, whilst they appreciate that companies are not required to disclose information that would be prejudicial to the interests of the company.

ACs should be specific as to how they addressed significant issues

Investors would like companies to move away from generic statements or assertions indicating that the AC has dealt with a significant issue. They want to understand what dealing with an issue entailed and how the AC provided a robust level of challenge to management, including the key areas of challenge and debate that the AC focused on, for each significant issue.

Reports which indicate that ACs have merely 'reviewed' areas such as impairment or revenue recognition are not considered sufficient by investors, whereas statements that indicate the sources of information and how it was evaluated, convey more insight on the nature and extent of the process.

Investors prefer the use of more descriptive, 'active' language in the past tense, as it provides assurance that the AC has positively taken action. For example, words such as 'examined', 'compared' and 'challenged' provide more colour in relation to the AC's actions than 'reviewed' or 'received'.

Key themes: providing context

The context of issues can be better understood by investors when details are provided to cover aspects such as:

- What is the underlying issue – does it relate to a specific:
  - transaction or type of transaction?
  - location or unit of the business?
  - product or contract?
  - existing or emerging risk?
- What is the nature of the judgement being made – is it:
  - an accounting policy choice?
  - a specific assumption, estimate, or valuation?
  - a decision on disclosure?
  - consideration of whether the financial statements provide a true and fair view?
- What was the conclusion, and the factors and reasons considered to reach the final outcome, including the:
  - sources of assurance?
  - steps taken for the AC to maintain an independent mind-set?
- Does the outcome affect:
  - the scope of activities included in the consolidated financial statements?
  - an amount reported as an asset, liability and/or a measure of performance or cash flows?
  - the extent of disclosure?
- Are there any other aspects of the issue necessary to convey its context clearly?

Where applicable, and not disclosed elsewhere, investors also appreciate that the AC mention the range of scenarios factored in and key assumptions, commenting on whether outcomes fall within an acceptable range of outcomes. Ranges of outcomes give perspective to investors and are invaluable in assessing companies for potential investment as well as considering whether to retain or dispose of an investment.

Many investors believe that the AC should not put an undue level of reliance on the external audit function. In light of this, it is particularly important that the AC articulates how they satisfy themselves that the external auditors have employed an appropriate level of professional scepticism in fulfilling their responsibilities. Some investors also caution that it is not the role of the AC to become an auditor, but to ascertain the robustness of the audit process and report their findings to the board for consideration.

While considering the main audience for reporting can be important, most investors agreed that disclosure should be sufficient to provide an understanding of the issue, what the AC did, and the conclusion – both the reason for it and the consequences of it. Some investors may additionally engage with the AC to obtain further details that are of interest to them, but covering the main dimensions of a topic in the AC's reporting could be helpful in avoiding potential issues around selective disclosure.

No need to repeat what is already disclosed in the annual accounts

Repetition in the AC report of disclosures included in other sections of the annual report is not seen as helpful by investors as this would ultimately contribute to cluttering. Investors require insight in the AC reporting as to what the issues were and what the AC has done to resolve them, but some of the context may already be disclosed elsewhere.

It is suggested that companies take care to ensure information is disclosed in the most appropriate place in the annual report and accounts. In some cases, this may lead to consideration of the current level of disclosure elsewhere, and whether enhancements might improve the ability to cross refer from the AC's reporting to this disclosure.

Investors indicate that cross referring the significant issue disclosure to the notes to the accounts or elsewhere:

- assists them in understanding the issues that have been disclosed in the AC report in more detail without repeating the information;
- is helpful and time-saving by highlighting where to look for further detail; and
- illustrates that the AC is satisfied with how the significant issues have been disclosed in the annual report.

Investors Views:

"The utility of the AC reporting is that it augments what is disclosed elsewhere."

"Adding a bit of flavour to the issues is enough, there is no need to go into too much detail. We just want 'hooks' to understand the issues and ask the right questions."

"Smaller investors will not have a chance to engage with the AC. They would appreciate not only the 'hooks' but the 'hangers' so they can more fully understand issues with no need of follow up questions."

Company Views:

"It will be hard to contextualise any issues discussed between auditors and management."

"There's a necessity to balance what investors want with what is practical and efficient to produce."

Lab comment

Lab project: Accounting Policy Disclosures and Integration of Related Financial Information

The Lab is currently conducting a project considering:

- Accounting Policy Disclosure
  - omitting immaterial policies
  - whether 'boilerplate' text should be cut as clutter or enhanced
  - disclosure where there is no policy choice, policy choices and changes, key judgements, assumptions and estimates, new IFRS requirements adopted and those not yet adopted
  - presentation of policies within a single note or integrated within respective footnotes
  - identifying more (or less) significant policies, policies being reported outside or within a separate section of the annual report
- Notes to the accounts
  - integration of separate notes on the same topic
  - ordering the notes
- Financial Review
  - integration of financial statement information and the financial review

Through this project the Lab expects to encourage higher quality accounting policy disclosures which may help cut clutter and aid AC reporting in relation to accounting policy issues.

Example disclosures: Addressing significant financial statement reporting issues

The following selected AC disclosures illustrate several approaches taken by participant companies. While these disclosures do not fully address the points raised by investors, enhancements are expected to be evolutionary, and they are shown here to illustrate some of the practices that are already evident.

The Aveva example received praise from many project participants for demonstrating effective, concise communication.

Old Mutual – December 2012

"Impairment of the carrying value of goodwill (see Note F1 to the Accounts). The committee reviewed the assumptions used to justify no impairment to goodwill this year and was comfortable with them. In particular, the committee reviewed the carrying value of goodwill and other intangibles relating to the Old Mutual Wealth businesses in continental Europe, now that certain countries are operating a closed book model. The committee agreed that the projected future cash flows from these businesses supported the carrying value of these intangibles, even though the carrying value would be unlikely to be realised on the open market given current market conditions."

Aveva – March 2013

"During the year, particular attention was paid to the carrying value of goodwill related to the Enterprise Solutions line of business for which there is lower headroom in the impairment test calculations. The committee examined the forecasts for this business and with its move to profitability during 2012/13 was comfortable that no impairment was required."

Barclays – December 2012

"We received reports on the assumptions underlying the provisions made for product mis-selling redress, specifically PPI and Interest Rate Hedging Products. The trend in PPI claims has proved to be volatile during 2012, resulting in provisions being taken in both the first quarter and the third quarter. A provision for Interest Rate Hedging Products was taken at the half-year. We were content after due challenge and debate with the assumptions made and the judgements applied. As part of reviewing the results for 2012, we considered a recommendation from management that further provisions should be taken in respect of PPI and Interest Rate Hedging Products in the financial results for 2012 and, having reviewed the trend data and provisioning assumptions, agreed with management's recommendation."

Next – January 2013

"The Committee's review of the interim and full year financial statements focused on the following significant areas...

(a) Directory receivables and related provisions for doubtful debts which, at £601m, represent the largest asset on the Group's balance sheet...

These items were also addressed at the planning stage of the external audit and there were no significant disagreements between management and the external auditor's conclusions."

Vodafone – March 2013

"The judgements in relation to asset impairment largely relate to the assumptions underlying the calculation of the value in use of the business being tested for impairment, primarily the achievability of the long-term business plan and macroeconomic assumptions underlying the valuation process. This is particularly challenging in relation to the Group's interests in Southern Europe given lower medium-term visibility of economic and business performance and material changes in other valuation assumptions. The Committee addresses these matters through receiving reports from management outlining the basis for the assumptions used. Business plans are Board approved. In addition, this area is a prime source of audit focus and accordingly Deloitte LLP provide detailed reporting to the Committee."

Key to Project Observations

What investors value most from these disclosures:

Context:
- Quantification of the financial reporting issues [Next], especially if the related amounts are not provided elsewhere.
- Identification of the related product, business or geography [Aveva, Barclays, Old Mutual, Vodafone]

AC's actions in the year:
- Summary of the work performed by the AC illustrating how the AC satisfied itself of the appropriateness of the estimates and judgements made by management. [Aveva, Old Mutual]
- Indication of the sources of evidence that the AC referred to in performing their duties. [Barclays, Vodafone]

Conclusion/Outcome:
- Clear indication of the outcome, including the AC's conclusion. [Aveva, Barclays, Old Mutual, Next]

Reason for conclusion:
- Explanation of the key factor(s) leading to the conclusion. [Aveva, Old Mutual]

Integration:
- Cross references to the related financial statement information. [Old Mutual]

Use of active language and past tense:
- Indication of positive action by the AC using words such as "examined" or "agreed". [Aveva, Barclays, Old Mutual]

Assessing external audit effectiveness

There is a general presumption amongst some investors that the external audit is effective. However, other investors indicate a keen interest in the AC explaining how it has assessed effectiveness.

Extensive disclosure explaining the process followed by the AC could become repetitive year after year. Providing specific insight on activities undertaken and outcomes for the year should help to avoid this, as well as separately identifying standing data on policies and practices generally undertaken.

Some companies believe that it is very difficult for the AC to determine the level of challenge that management has been subjected to from external auditors, since issues have often been resolved before they are presented to the Committee members. Investors generally expect ACs to report concisely in relation to this, giving some colour as to what evidence they have seen and how they have assured themselves of the effectiveness.

Several participants also observe that there is generally a high quality of disclosure in relation to the work performed by the AC in an audit tender process, and would like to see disclosure of a similar quality in relation to the assessment of audit effectiveness.

Some companies conduct surveys on performance which may reveal subtle nuances and changes from year to year, and may help to flag changes in effectiveness in certain areas of the audit. If such surveys are viewed by the AC as part of this process, investors encourage the AC to describe the survey, results and any actions taken.

In addition, investors commented that if ACs review inspection reports from independent audit regulators, this should be disclosed along with an indication of any resulting actions.

Investor Views:

"Current Audit Committee reporting has a lot 'in the letter', not much 'in the spirit'."

"One paragraph of specifics is better than five paragraphs of process."

Company Views:

"It is difficult for the AC to determine the level of challenge that the auditor has provided to management, as most of the issues are already closed when they get to us."

Lab comment

Competition Commission decision on the audit market

In October 2013, the UK Competition Commission published the findings of its investigation into statutory audit services. Its final remedies include that:

- FTSE 350 companies tender their audit at least every ten years, and if the company chooses not to tender at five years, the AC reports in which year it plans to tender and why this is in the best interests of shareholders;
- The FRC's Audit Quality Review (ACR) team review every FTSE 350 audit on average every five years, and that the AC report the findings of any AQR report concluded on the company's audit during the reporting period, stating the grade awarded and how the AC and auditor are responding to the findings;
- Measures to strengthen the accountability of the auditor to the AC and reduce the influence of management, including that only the AC is permitted to negotiate audit fees and influence the scope of audit work, initiate tendering, make recommendations on appointment, and authorise non-audit services performed by the auditor; and
- An advisory shareholders' vote on whether the AC's reporting is satisfactory.

Most of its remedies are expected to come into force from late 2014.

Example disclosures: Assessing external audit effectiveness

ITV volunteered to draft the following example disclosure on assessing external audit effectiveness, on the basis of what the disclosure could look like, assuming that there are no significant findings when conducting the assessment this year. The disclosure separates the specific year's focus from steps taken in the ongoing assessment process.

ITV – Draft disclosure for 2013

The Committee places great importance on ensuring there are high standards of quality and effectiveness in the external audit process.

Last year the Committee conducted a tender process for external audit services, KPMG having been ITV's auditors since the tender that followed the Group's formation in 2004. The main outcomes of the process were; the reappointment of KPMG, and a plan for the development of the external audit approach over a two to three year period. The principal planned changes were:

- The scope of the external audit will consider developments in certain areas of the business earlier than might have been considered necessary on a traditional assessment of financial materiality, such as direct consumer revenues from the ITV Pay player; and
- The development by management of a suite of IT driven analytical tests using data from ITV finance systems, highlighting exceptions from the norm and performing routine audit tests across the year which would make the control environment both stronger and more efficient and could support internal and external audit's systems evaluation and testing.

In recommending the reappointment of KPMG Audit plc, the Committee also considered the findings from its on-going assessments of auditor quality, effectiveness and performance.

There were no significant findings from the evaluation this year.

Ongoing assessment process

Audit quality is reviewed throughout the year with the focus on: strong audit governance; the firm's methodology and its effective application to ITV; robustness of challenge and findings on areas which require management judgment; and the quality of the senior members of the audit team.

In addition, the effectiveness of the audit is also assessed throughout the year using a number of measures, including but not limited to:

- Reviewing the quality and scope of planning of the audit and its responsiveness to changes in our business;
- Implementation of planned improvements identified in the audit tender process;
- Monitoring the independence and transparency of the audit;
- Reviewing of the Financial Reporting Council's Audit Quality Review (AQR) reports for KPMG and other audit firms; and
- Seeking feedback from KPMG on any external or internal quality review of our audit.

Further, at the conclusion of each year's audit the Committee performs a specific evaluation of the performance of the external auditor. This is supported by the results of questionnaires completed by the executive Directors and relevant senior management, covering areas such as quality of audit team, business understanding, audit approach and management. Where appropriate, actions are agreed against the points raised and subsequently monitored for progress.

Key to Project Observations

Investors prefer reporting that describes the specific activities undertaken by the AC in order to assess whether an external audit process has been effective, such as:

- Review of the risk identification process followed by the auditor at the beginning of the audit cycle.
- Review of inspection reports from independent audit regulators.
- Leading the evaluation, conducted by way of a survey, of external auditor performance against certain criteria.
- Ensuring that auditors deliver on any factors considered in their appointment.
- Assessing the level of challenge provided by the auditors to management throughout the audit.

In presenting this information:

- Investors recommend that there should not be a 'one size fits all' process or disclosure.
- Balance should be maintained between providing sufficient colour specific to the company and proving lengthy process descriptions.
- Reporting should not be cluttered with unnecessary detail.
- The use of past tense more clearly distinguishes actions taken from generic policy statements.
- Active and descriptive language brings to life the specific steps taken by the AC.

Appointing the auditor and safeguards on non-audit services

Appointing the auditor

One of the new provisions of the Code is that FTSE 350 companies should put the external audit contract out to tender at least every ten years. Investors appreciate that tendering should become part of the normal business cycle.

Until fairly recently, companies tendered audit contracts and changed external auditors relatively infrequently. When tenders did occur they were seen by some investors as a danger signal indicating potential disagreements between management and the auditor, rather than as a mark of good governance.

Investors would like companies to disclose in advance, their tendering policy and the intention to tender once this has been agreed. This would make clear to investors when tendering is not as a result of disagreements or relationship issues, but instead, is a planned discipline.

Shareholders would also like the opportunity to be more involved in the process of appointing auditors rather than merely being faced with a vote on the Board's decision at the Annual General Meeting.

Some opportunity to engage in auditor appointment is considered better than no opportunity. Investors are part of the stewardship chain and if they are concerned by an issue related to auditor appointment, involvement at the planning stage of a tender would offer the chance to consider, for example, the selection criteria that the company plans to use.

Investors note that some companies participating in the project provide detailed, understandable disclosures of the tendering process, including the involvement of senior company representatives and the AC. Understanding why the company has appointed a specific external audit firm is important to investors as a basis to assess whether an auditor has been selected for the right reasons.

Investors agree that there is also value in disclosing when the last tender occurred, the name of the current audit partner, and information on partner rotation and the length of time that the company has been audited by the current audit firm.

Safeguards on non-audit services

Some investors consider that detailed policies in relation to non-audit services and aspects of how auditor objectivity and independence is safeguarded are not of great interest and could be disclosed on the company's website as long as they have been clearly linked and referenced in the AC reporting.

In contrast, other investors note that they appreciate a summary of the policies on non-audit services to be disclosed as part of the AC reporting, including whether all non-audit services are tendered and subject to different degrees of pre-approvals and internal scrutiny.

Additionally, a few investors would like companies to disclose their policy on hiring of senior employees from their audit firm and safeguards in place to assure them that auditor independence is not compromised.

If there is any change to the company's policy on non-audit services, investors agreed that they would like this fact to be disclosed with an explanation as to what the changes have been and the reason for them.

They also expressed a preference for the detail and amount of non-audit services to be described beyond generic classifications (for example, specifying the nature of tax services provided), in the AC report. Investors do not expect ACs to repeat data already included in the annual accounts and appreciate cross references to the financial statements.

Some investors indicate that the ratio of non-audit fees to audit fees forms part of their process to decide whether to invest in a company. Disclosing the percentage provides a clear measure of the outcome of applying the policy. An explanation as to why this ratio may be high, particularly if it continues to be relatively high over time, provides more qualitative insight on the reason this may be the case.

Lab Comment

Audit tenders: notes on best practice

Following introduction in the Code of a provision for FTSE 350 companies to tender their audit contract every ten years (on a comply or explain basis), the FRC was asked by AC chairmen and others to provide some practical examples of how a tender might be conducted.

In July 2012, the FRC published suggestions to help companies undertake an efficient audit tender process. The document *Audit tenders: notes on best practice* aims to provide companies and ACs with real life examples which they may wish to consider as they design their own tender processes.

See this document at:
www.frc.org.uk/Our-Work/Publications/Corporate-Governance/Audit-Tenders-Notes-on-best-practice.pdf

Example disclosure: Appointing the auditor

Schroders – December 2012

"In the 2011 Annual Report we reported that the Committee would review the credentials of other providers of external audit services. A wide-ranging request for information (RFI) was issued not only to the 'Big Four' audit firms (PwC, KPMG, Ernst & Young, and Deloitte), but also to two firms in the next tier. This covered their capability to conduct the audit and other non-audit services provided by accounting firms to the Group. In July, the Committee decided, in light of developing EU regulation and UK market practice and the information gleaned from responses to the RFI, that it would be appropriate to conduct a tender exercise for the external audit. Schroders had not previously put its audit out to tender. Due to the Group's relative complexity and geographical spread, the two firms outside the 'Big Four' were not invited to participate and the request for proposal was limited to those global providers with the necessary resources to audit a diverse global Group.

In September 2012, a request for proposal (RFP) was issued to provide the following external audit and audit-related services:

- the audit of Schroders' parent Company, the Group accounts and those of certain subsidiaries;
- to report, in the Annual Report, whether certain remuneration and governance disclosures were in accordance with applicable legislation and rules/regulations;
- to review the interim financial statements;
- regulatory reporting in various locations;
- client asset reporting to the FSA or its successor bodies; and
- controls reporting in various locations.

The four firms participating in the tender process were required to submit their proposals against the following criteria:

- organisation and capability – including the firm's global coverage, experience, scope of service, technical expertise and support, culture and independence assurance;
- audit approach and delivery – including knowledge of the business, audit planning process, quality of accounting judgements, liaison with and reliance upon Internal Audit, timely resolution of audit issues and transition experience;
- audit quality – including quality assurance, audit effectiveness, audit reporting, integrity, independence, objectivity, process improvement and added value;
- resourcing and engagement team – including quality of proposed audit team, skills and personal qualities of audit partners and leadership, team structure, resourcing model and succession, responsiveness; and
- fees and terms.

The process comprised three stages:

- 28 interviews for each firm with Schroders personnel including the Chairman, Executive Directors, Audit and Risk Committee members and key members of management (both UK and globally);
- written proposals; and
- a presentation to the Committee and the Chairman, the Chief Executive, the Chief Financial Officer, Bruno Schroder, the General Counsel, the Head of Financial Reporting and the Company Secretary.

All four firms met the criteria for appointment; the Committee concluded, however, that two firms, PwC and KPMG, demonstrated better the resource, expertise, quality control and audit approach to deliver a high-quality audit service to Schroders.

As part of the process to confirm the independence of the audit firm prior to making a recommendation to shareholders, KPMG advised the Company that it did not meet the regulatory requirements for independence for all relevant Group companies. As Schroders' incumbent auditor, PwC had maintained its independence throughout the process.

Independence is a pre-requisite for an audit appointment and therefore the Committee has recommended that the Board propose to shareholders that PwC be re-appointed as the Company's auditors for the 2013 audit."

Project Observations

In this area, it is clear that much development is needed, given the increasing propensity for audit tenders.

Investors commented that the Schroders disclosure describes a very thorough, understandable tendering process. The extent of the detail provided gives investors confidence in the robustness of the tendering process.

In addition, investors noted that they appreciate the clarity in describing the process and the key factors considered by the AC to decide the outcome.

References to involvement of very senior company representatives gives further confidence in the seriousness of the process.

Investors also commented that the key question they want answered in these disclosures is "Were the auditors appointed for the 'right' reason?"

Example disclosures: safeguards on non-audit services

The company disclosures shown illustrate some of the characteristics that investors are looking for. Recurring information, for example on policies – as distinct from information on current year activities and outcomes – could easily be distinguished in the reporting.

Barclays – December 2012

"The Committee's responsibility to monitor and review the objectivity and independence of the external auditor is supported by a policy to govern the non-audit services that may be provided by the external auditor. The policy sets out the circumstances in which the external auditor may be permitted to undertake non-audit services. Allowable services are pre-approved up to but not including £100,000, or £25,000 in the case of certain taxation services. Any non-audit service that exceeds these thresholds requires approval from me as Chairman of the Committee and must be robustly justified and, if appropriate, tendered, before it is approved. I closely review all requests for approval, particularly any which concern taxation-related services, and specifically tax advisory services, where our approach is not to use the auditor unless there is a very strong case for not seeking an alternative supplier. The Committee receives a quarterly report on non-audit services undertaken by the auditor so that it can monitor the types of services being provided and the fees incurred.

A breakdown of the fees paid to the auditor for non-audit work may be found in note 44 on page 310. Significant categories of engagement undertaken in 2012 include tax compliance services for assignments initiated pre-January 2011 in connection with our expatriate and international assignees and attest and assurance services in connection with the production of a report attesting to the effectiveness of controls in place at some of Barclays US based entities. In each case, approval was only given after a full and thorough assessment of the value case for using the auditor and of the skills and experience that the auditor would bring to each assignment. I also satisfied myself that there were safeguards in place to protect the objectivity and independence of the auditor."

ITV – December 2012

"... The policy is based on the five key principles which underpin the provision of other services by the external auditor. These are that the auditor may not provide a service which:

- places them in a position to audit their own work;
- creates a mutuality of interest;
- results in the auditor developing close personal relationships with ITV employees;
- results in the auditor functioning as a manager or employee of ITV; or
- puts the auditor in the role of advocate for ITV.

The policy is reviewed annually and is available in full on the Company's website at www.itvplc.com/about/governance."

Vesuvius – December 2012

"The policy sets out the categories of work that the Auditor is prohibited from undertaking. Other than these, the Company does not impose an automatic prohibition on the Auditor undertaking non-audit work. The Auditor is eligible for selection to provide non-audit services that are not, or are not perceived to be, in conflict with auditor independence, provided it has the skill, competence and integrity to carry out the work in the best interests of the Group.

An annual budget for non-audit related fees which the Group is proposing to pay to the Auditor is presented for pre-approval to the Audit Committee. Any individual assignment where the fee is likely to be in excess of £50,000 must be pre-approved by the Audit Committee. Where appropriate, services are tendered prior to awarding work to the Auditor."

"Of the total non-audit related fees paid to the Auditor in 2012 of £2.9m, £2.3m related to audit and accountancy work associated with the demerger of Cookson Group, for which it was concluded that KPMG was best-placed to support the Company."

Key to Project Observations

What investors value most from these disclosures:

Policies
- Some colour as to what the company's policies are. [Barclays, Vesuvius]
- Although FRC Ethical Standards for auditors define the non-audit services that the external auditor is prohibited from performing, a brief reminder is useful. [ITV]

Process/work performed by the AC and sources of information
- Indication of activity performed by the AC for the year. [Barclays]

Conclusion/outcome
- Explanations as to the nature of the non-audit fees. [Barclays, Vesuvius]

Integration/Cross-referencing
- Reference to the company's website for further detail. [Barclays, ITV]

Use of 'first person' reporting
- Reflects clear accountability by chairman on behalf of the AC. [Barclays]

Project process

The Lab has been set up to facilitate testing with investors of approaches to disclosure put forward by companies, and a key requirement to ensuring a successful project is getting support from the company and investor communities. We appreciate the input received from all project participants.

Involvement of companies

The following 19 companies volunteered to participate in this project by agreeing to have investors comment on their AC reporting practices included in their latest annual reports and on their developing ideas:

- Alliance Trust
- AstraZeneca
- Aveva
- Barclays
- BG Group
- Cairn Energy
- Cobham
- Drax
- ITV
- Next
- Old Mutual
- Premier Oil
- Rio Tinto
- RSA Insurance
- Schroders
- Smith & Nephew
- Unilever
- Vesuvius
- Vodafone

Since changes to the Code are effective for accounting periods beginning on or after 1 October 2012, the AC reporting examples used in this project were not yet required to comply with the new requirements set out in the Code.

Involvement of investors

There has also been a considerable amount of support for this project from the investment community. The Lab held mainly face to face interviews with individuals from the following 20 analyst and investor organisations:

- Alliance Trust
- Allianz Global Investors
- BlackRock Investment Management
- F&C Asset Management
- Fidelity Worldwide
- Fitch Ratings
- Governance for Owners
- Hermes Equity Ownership Services
- HSBC Global Asset Management
- Invesco Perpetual
- Legal and General Investment Management
- M&G Investments
- Newton Investment Management
- RPMI Railpen
- Schroders Investment Management
- Scottish Widows Investment Partnership
- Standard Life Investments
- Threadneedle Asset Managers
- UBS Global Asset Management
- USS Investment Management

In addition, the Lab met with representatives of the following six investor associations:

- Association of British Insurers
- CFA Institute
- CFA Society of the UK
- Investment Management Association
- National Association Pension Funds
- UK Shareholders Association

Project process

The Lab project team developed a set of questions that served as the basis for initial discussions with companies and investors.

Investors were then sent examples of current AC reporting of participating companies. Some of the companies participating in the project also provided additional support by developing examples that complemented current reporting practices. These examples were also shared with investors as they became available to provide additional ideas for consideration.

Members of the investment community were asked for their views on the examples of current and developing reporting practices.

Lastly, a meeting between companies and investors was held in September 2013. At that meeting, participants considered a draft of this Report and were able to discuss the desired balance to be achieved between what investors would like to see disclosed and what companies are able to disclose without undue cost or difficulty to meet the requirements of the revised Code.

Other reports published by the Lab:

March 2013: Reporting of pay and performance

February 2013: Presentation of market risk disclosures

November 2012: Debt terms and maturity tables

November 2012: Operating and investing cashflows

September 2012: Net debt reconciliations

June 2012: A single figure for remuneration

Do you have suggestions to share?

The Lab encourages readers of this Report to provide comments on its content and presentation. As far as possible, comments will be taken into account in shaping future projects. To provide comments or suggest other areas of corporate reporting for potential future projects, please send us an email at: FinancialReportingLab@frc.org.uk

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