Financial Reporting LAB

Lab implementation study:

Reporting of Audit Committees –

how companies responded to investor needs identified by the Lab; experience of the first year

May 2015

FRC Financial Reporting Council

Summary of findings

Given the number of changes to reporting that companies had to comply with in the 2013 – 14 reporting season, it is pleasing to see the progress made by companies in their Audit Committee (AC) reporting. While the majority of companies sought to comply with the requirements, a small number went beyond them.

This Lab implementation study of AC reports of 34 companies from across the FTSE 350 has identified the following in relation to investor preferences detailed in the Lab's project report, Reporting of Audit Committees:

- **Style of the audit committee report** – 82% of companies presented their AC report as a separate report and all committees wrote in the first person. 62% included a photo and 24% included the signature of the AC chair; both are ways to personalise the report preferred by investors.
- **Significant reporting issues** – 94% of issue disclosures contained clear context and 84% detailed the AC's actions, but improvement in explanations to make each issue disclosure specific to the company and to include the conclusion reached by the AC and the rationale could be made.
- **Assessing external auditor effectiveness** – 41% of companies provided a reasonably good level of detail of their assessment process. The FRC has issued practice aid to assist in AC's carrying out this assessment and hope that this will prompt further improvement in reporting.
- **Appointing the auditor** – disclosures largely meet investor preferences, but clarity in relation to timing of next audit tender, and current audit partner tenure, rotation, and name should be considered; and
- **Safeguards on non-audit services** – 94% of AC reports included the non-audit services policy and 73% described the criteria for AC approval. However, improvement in reporting of the nature of non-audit services received, together with the relevant fee, and clearly stating the ratio of non-audit to audit fees, could be made by many companies.

The Lab encourages audit committees to continue to improve their reports to better communicate with investors, and recognises that some may be taking further steps in the second year of implementation.

Background and scope

The Financial Reporting Lab (the Lab) published its Lab project report: Reporting of Audit Committees in October 2013, to provide insight from companies and investors on effective Audit Committee (AC) reporting of the following areas of the revised UK Corporate Governance Code (the Code), applicable for years beginning on or after 1 October 2012:

- 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 with particular regard to to non-audit services.

In addition the Lab report considered investors' preferred style for the AC report.

Simultaneously with the revised Code, the Financial Reporting Council (FRC) introduced the requirement for an extended auditor report which includes disclosures on significant audit matters and information in relation to matters communicated by the auditor to the AC which are not adequately covered in the AC report.

The FRC has recently published the following reports which are relevant to these changes:

- Developments in Corporate Governance and Stewardship 2014 - the FRC's annual assessment of the state of corporate governance and stewardship in the UK and the quality of compliance with the codes;

- Extended auditor's reports: A review of experience in the first year - An in-depth study of the first year of extended auditor reporting, including a comparison of AC reporting of significant issues and auditor reporting of significant risks; and

- Audit Quality: Practice aid for audit committees - developed by the FRC based on roundtables held with company, investor, financial management and auditor representatives, following feedback from AC members that guidance in assessing auditor effectiveness would be useful.

This Lab implementation study considers more specifically how well companies have implemented investors' preferences highlighted in the Lab report. We have not tested whether investor preferences have changed since the report's publication. A random sample of 34 companies from the FTSE 350 were selected for this implementation review.

Style of the AC report

Lab Report: Attributes Preferred by Investors	Percentage of Companies Implemented
Separate report	82%
Written in the first person	100%
Include photo of AC Chairman	62%
Include AC Chairman's signature	24%

Findings

While all companies in the sample complied with the Code requirement for the AC report to be a separate section within the annual report, it is encouraging to see 82% presented their AC report as a separate report (as preferred by investors in the Lab project), most commonly in the Governance section of the Annual Report, rather than as part of another report. Three companies presented their AC report in its own section of the Annual Report.

Investors' preference for personalisation of the AC report has been partially implemented by companies, with all writing the report, or introduction / letter, in the first person, and 62% including a photo of the chairman. Only 24% included the AC chairperson's signature.

Key messages

Overall, companies have implemented the Lab's findings well, but personalising the report by adding the AC Chair photo and signature would go further to meet investor preferences based on building the perception of accountability.

Significant reporting issues considered by the AC

Interaction in reporting of estimates and judgements

Findings

In the Lab's project Accounting policies and integration of related financial information (report published in July 2014, after the majority of companies included in this sample reported), investors indicated there should be interaction of the reporting of estimates and judgements across the AC report, auditor report, and accounting policy disclosures. While many ACs have included significant issues in relation to impairment considerations, investors are also interested in AC estimate and judgement considerations in other areas of accounting (e.g. complex customer and supplier contracts). If a detailed, informative description is provided in the accounting policy disclosures, AC and auditor reports can focus disclosure on their own actions and refer to the detailed description. This is also an area of focus for the FRC's Corporate Reporting Review, as highlighted on page 2 of its Corporate Reporting Review: Annual Report 2014.

Significant reporting issues considered by the AC (continued)

Significant Issue Disclosure	Finding
Average number of significant issues reported	4.6
Total number of issues reported by the 34 companies in the sample	157
Percentage of companies whose reporting of significant issues (per issue) were rated by the Lab as:	
- Very Good (average of all 5 attributes[1]	0%
- Good (average of 4-4.9 attributes)	21%
- OK (average of 3-3.9 attributes)	38%
- Improvement Required (average of 2-2.9 attributes)	23%
- Significant Improvement Required (average of 0-1.9 attribute)	18%

Findings (continued)

Reporting of significant issues has been implemented to varying levels by AC’s. 59% of companies have made a reasonable attempt (those graded “Good” or “OK” by the Lab). Even companies with disclosure of a significant issue which covers all the attributes identified as helpful by investors, include disclosure on other significant issues which falls well below the bar set by investors. One company in our sample did not report any significant issues considered by the AC.

1 - Refer to page 7 of this report for details of the five attributes

Significant reporting issues considered by the AC (continued)

Significant Issue Disclosure	Finding
Percentage of significant issue disclosures containing each attribute identified in the Lab report:	
- Issue specific to the company and its circumstances	52%
- Context of the issue provided	94%
- AC's actions in relation to the issue	84%
- Conclusion reached by the AC	65%
- Rationale for conclusion provided	20%
Number of significant issue disclosures with all 5 attributes	14 (9%)
Number of companies with at least one significant issue disclosure with all 5 attributes	11 (32%)

Findings (continued)
Explanations are often at a high level, with 48% not made specific to the company. While the majority of issue disclosures included context, it was not always clearly written. Surprisingly, 16% of issue disclosures did not detail the specific actions taken by the AC, and disclosure of the conclusions reached and their rationale were even more lacking. It is possible that many AC's took the view that the conclusions and rationale were obvious to the reader.

Key messages
Improvement is recommended for the majority of companies in relation to the depth and quality of explanations. Also, to meet investor expectations, detailed explanations of considerations by the AC in relation to accounting judgements and estimates (not only impairment considerations which are often disclosed) could be included.

Assessment of external auditor effectiveness

Disclosure on assessment of external auditor effectiveness	Finding
Disclosure includes attributes suggested in the Lab report:	
- Reference to an audit inspection review (firm or individual company)[2]	21%
- Reference to an internal staff survey on auditor effectiveness	23%
Overall rating of level of detail provided on the assessment process (not an assessment of the criteria used):	
- Good, but room for improvement	41%
- Improvement required	59%

Findings

The Lab report noted that investors call for more detailed, but concise disclosure of the assessment of external auditor effectiveness, similar to the high quality disclosure seen in relation to the AC work performed during a tender process. Investors expect disclosures to provide insight into activities undertaken and their outcomes in performing the assessment.

Only a small proportion of companies referred to specific activities undertaken together with the results of the activity, in their assessment. Only 23% of companies in our sample mention their use of a staff survey; of these, 62% did not mention the findings of the survey.

The Lab judged that 41% of companies include detailed disclosure of their process for assessing effectiveness, although the majority of disclosures did not include the results of each step taken.

Key messages

Most companies have significant room to improve reporting in this area, by providing more detail on the activities undertaken and each of their outcomes. Companies are aware of the need to improve reporting in this area and have requested guidance be developed. The FRC has responded by publishing guidance in this area, as noted on page 3 of this report.

2 - FRC PN 69/14 advises AC's that where a company's audit has been reviewed by the AQR, AC's should discuss the findings with their auditors and consider whether any of those findings are significant for assessing external auditor effectiveness and, if so, make appropriate disclosures. AC's should not disclose the inspection grade.

Appointing the auditor

Lab Report: Attributes of Good Disclosure	Finding
Tendering policy	88%
Specific timetable for next tender	15%
Date external audit last tendered	85%
Name and tenure of audit firm	97%
Tender during the year reported on	9%
Name of audit partner	23%
Tenure of current audit partner	59%

Findings

Companies have included a number of disclosures requested by investors, particularly the audit firm name and tenure, the date the audit was last tendered, and the company's tendering policy. While the proportion of companies disclosing the name of the partner in this area of the annual report is only 23%, the partner's name can be found on the audit report. While 85% of companies included the date the audit was last tendered, only 15% include a specific timetable for the next tender, meaning it is unclear to investors when the next tender will occur.

Key messages

Companies have generally responded well to investor suggestions in this area. There is still room for improvement, particularly in relation to current audit partner tenure and rotation, and clarity in relation to expected audit tender date.

Safeguards on non-audit services

Lab Report: Attributes of Good Disclosure	Finding
Non-audit services policy	94%
AC approval criteria	73%
Description of non-audit services beyond ‘generic’ categories	50%
Ratio of non-audit to audit fees	62%
Fees paid for each service listed	56%
Cross reference provided to financial statements note on fee disclosure	68%

Findings

Almost all companies disclose their policy in relation to non-audit services. 73% of companies disclose that AC approval is required for certain services, with 47% indicating a fee limit above which AC approval is required.

In the Lab’s project, investors indicated they are particularly interested in understanding the services received (beyond generic categories), the relevant fees and the overall ratio of non-audit to audit fees paid to the audit firm.

Key messages

AC’s have been reporting on this area for some time, but improvement is required to fully meet investor needs.

To Read The Lab's Reports

The full range of Lab reports can be downloaded freely from: https://frc.org.uk/Lab/Reports.

What is the Financial Reporting 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 what investors find useful. It is the responsibility of each reporting company to ensure compliance with relevant reporting requirements.