



Governance in Brief

Your summary of the latest corporate governance developments

Headlines

- FRC sets out proposals to improve the effectiveness of company stewardship by boards and audit committees.
- FRC to explore best practice by UK boards in determining and managing their level of risk.
- New guidance for audit committees on the provision of non-audit services.
- APB tightens the non-audit services regime.
- BIS to publish policy proposals on the future of narrative reporting in time for the 2011 Budget.
- New clarified auditing standards impose more requirements on auditors.

FRC sets out proposals to improve the effectiveness of company stewardship by boards and audit committees

In Brief: The FRC has launched a paper which considers how the effectiveness of the stewardship role of boards and audit committees can be enhanced through corporate reporting and audit. It is hoped that the example set by the best in corporate reporting can be adopted across the market so that annual reports, including audited financial information, deliver greater value to investors and serve the public interest better.

The FRC's aim is to see:

- higher quality narrative reporting, particularly on business strategy and risk management;

- more widespread recognition of the importance of Audit Committees and, therefore, greater emphasis on their contribution to the integrity of financial reporting;
- greater transparency of the way that Audit Committees discharge their responsibilities in relation to the integrity of the Annual Report, including oversight of the external auditors;
- more information about the audit process, both for Audit Committees and for investors and a broadening of the scope of the auditor's responsibilities; and
- more accessible Annual Reports through the use of technology.

To achieve these aims the following proposals are put forward for consideration and debate:

1. Directors should take full responsibility for ensuring that an annual report, viewed as a whole, provides a fair and balanced report on their stewardship of the business.
2. 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 directors' stewardship of the company, is based; and
 - transparency about the activities of the business and any associated risks.

3. The growing strength of audit committees in holding management and auditors to account should be reinforced by greater transparency through:

- fuller reports by audit committees explaining, in particular, how they discharged their responsibilities for the integrity of the annual report and other aspects of their remit (such as their oversight of the external audit process and appointment of external auditors); and
- an expanded audit report that includes a separate new section on the completeness and reasonableness of the audit committee report and identifies 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.

4. Companies should take advantage of technological developments to increase the accessibility, and reduce the cost of circulating, the annual report and its components.

5. There should be greater investor involvement in the process by which auditors are appointed.

6. The FRC's responsibilities should be developed to enable it to support and oversee the effective implementation of its proposals.

7. The FRC should establish a market participants group to advise it on market developments and international initiatives in the area of corporate reporting and the role of assurance and on promoting best practice.

8. The FRC would support the provision of a "safe harbour" defence to directors, officers and auditors to the extent that they make or give assurance in relation to forward-looking statements, and provided that such statements or judgements were not made recklessly, dishonestly or fraudulently.

The FRC will evaluate the responses to this discussion paper and hold a stakeholder conference on the key issues emerging from the consultation. It will also pilot a number of the initiatives proposed in the discussion paper.

We recommend that boards consider the implications of these proposals carefully and respond accordingly. The FRC acknowledges that the creation of a regulatory framework which eliminates the risk of failure is not desirable and has tried to avoid over-prescriptive proposals but it is important for those who will have to implement these proposals to determine whether they have achieved the right balance.

Date: 7 January 2011

Deadline for comment: 31 March 2011

Source: Financial Reporting Council

Further info: <http://www.frc.org.uk/press/pub2485.html>

FRC to explore best practice by UK boards in determining and managing their level of risk

In Brief: Stephen Haddrill, Chief Executive of the FRC, has said in a speech to audit committee chairs that the FRC wishes to explore how companies are responding to the new principle in the UK Corporate Governance Code that boards are responsible for determining the nature and extent of the significant risks they are willing to take in achieving their strategic objectives. He noted that there is a lot of deep reflection currently underway in boardrooms and committees, and that it was premature for the FRC to amend current guidance before new good practice had the chance to develop.

As a result the FRC will be holding a series of meetings in the New Year. Board chairs, audit and risk committee chairs, executives, investors and advisers will be invited to share their views and experience. Following the meetings, the FRC will decide how it can most usefully help boards and committees, including through an update of the Turnbull Guidance on risk management and internal controls if there is a need for this.

As part of the board's consideration of existing risk management practices, we recommend that the publication "Getting it right" produced by Independent Audit is consulted (see link below) for guidance on effective risk management procedures.

Date: 22 December 2010

Source: Financial Reporting Council

Further info: <http://www.frc.org.uk/press/pub2479.html>

Getting it right – http://www.icaew.com/index.cfm/route/168247/icaew_ga/Home/About_us/Latest_news/Getting_it_right__Latest_news__ICAEW/pdf

New guidance for audit committees on the provision of non-audit services

In Brief: Audit committees should take steps to improve the governance and transparency of the provision of non-audit services to the company by their external auditors under revisions to section 4 of the FRC's Guidance for audit committees. The FRC encourages companies to use the revised Guidance with effect from 30 April 2011.

The new guidance recommends that audit committees should:

- consider the effect the external auditor undertaking aspects of the internal audit function may have on the effectiveness of the company's overall arrangements for internal control and investor perceptions in this regard (new 4.8);
- keep the policy in relation to the provision of non-audit services by the auditor under review (addition to 4.29);
- set and apply a formal policy specifying the types of non-audit service (if any) for which (a) the use of the external auditor is pre-approved, (b) specific approval from the audit committee is required before they are contracted, or (c) the external auditor is excluded (new 4.30-4.32);
- disclose to shareholders, as early as practicable, instances where the audit engagement partner will, on grounds of audit quality, continue in position for an additional period of up to two years in excess of the usual five and the reasons for this decision (new 4.36); and
- provide an explanation in the annual report, or on the company's website, as to how auditor objectivity and independence is safeguarded if the auditor provides non-audit services in sufficient detail to cover each of the elements described in the third bullet above. In addition the audit committee's report within the annual report should set out, or cross-refer to, the fees paid to the auditor for audit services, audit related services and other non-audit services. Where the auditor provides non-audit services, other than audit related services, the annual report should include an explanation for each significant engagement of what the services are, why the audit committee concluded that it was in the interests of the company to purchase them from the external auditor (rather than another supplier) and how auditor objectivity and independence has been safeguarded. (new 4.38). A template for the provision of the fees information by the auditors to the audit committee is set out in Appendix A to Ethical Standard 1 issued by the Auditing Practices Board and might usefully be used in preparing the company's own disclosure. This template provides two distinct columns, one for audit related services and another for non-audit related services.

We encourage audit committees to initiate a full and proper debate on the new recommendations and to take advantage of the 30 April 2011 effective date for the revised Guidance, rather than rush through new procedures without detailed consideration.

Date: 17 December 2010

Source: Financial Reporting Council

Further info: <http://www.frc.org.uk/corporate/auditcommittees.cfm>

APB tightens the non-audit services regime

In Brief: In addition to the revisions to the Guidance for audit committees discussed above the APB has made parallel revisions to the Ethical Standards for auditors which place additional restrictions on specific non-audit services. The revised standards apply to periods commencing on or after 1 January 2011 but do not take effect until 30 April 2011.

Some of the changes include:

Restructuring services – the standard now includes specific restrictions that the auditor should not provide restructuring services if that may give rise to a self review threat in the course of a current or future audit unless appropriate safeguards are put into place. Certain restructuring services are permitted for listed entities, or significant affiliates thereof, in distress.

Valuation services – these services can only be performed where a law or regulation requires the auditor to provide the valuation. Under the previous rules valuation services could be performed where the law or regulation permitted the auditor to provide the valuation.

Tax services – Ethical Standard 5 has been clarified to indicate that auditors of listed companies or significant affiliates thereof shall not undertake to prepare current or deferred tax calculations that are, or may be, reasonably expected to be used when preparing accounting entries material to the financial statements, except in an emergency. This is not intended to prevent an audit firm preparing tax calculations after the completion of the audit for the purpose of submitting tax returns.

Contingent fees – contingent fees may not be charged for a non-audit service where the fee is material to the firm or the outcome of the service is dependent on a future or contemporary audit judgement relating to a material matter in the financial statements of the audited entity or on a new or uncertain tax law interpretation. This does not prohibit a lower fee being charged where the engagement relates to a transaction that was either aborted or prematurely terminated for whatever reason.

Extended and internal audit services – it is not permitted to provide internal audit services to an audited entity where it is reasonably foreseeable that the auditor would place significant reliance on their own internal audit work for the purpose of their external audit or where they would undertake part of the role of management. Work that (a) does not relate to financial information and/or financial controls, (b) is not performed largely by the same team or (c) is performed on different terms and conditions is a non-audit service and will need to be assessed.

As noted above, we encourage boards not to rush into making policy changes without full and proper debate. The 30 April 2011 effective date may not allow sufficient time for the issues to be considered fully.

Date: 17 December 2010

Source: Auditing Practices Board

Further info: <http://www.frc.org.uk/apb/press/pub2470.html>

BIS to publish policy proposals on the future of narrative reporting in time for the 2011 Budget

In Brief: Some 89 responses have been received by BIS to its Future of narrative reporting consultation. In addition Edward Davey, Minister for Employment Relations, Consumer & Postal Affairs met representatives from the business and investment communities and other stakeholders and BIS ran three consultation workshops to discuss the issues raised by the consultation. After the consultation closed the Minister held a roundtable discussion with 26 interested parties to discuss the emerging findings and possible options.

The summary of responses published by BIS sets out a detailed analysis of the responses to individual consultation questions. However, a number of key themes have been noted from responses and the consultation workshops. Some noted that in general UK companies produce high quality reports but that there remained room for improvement particularly at the tail end where compliance with the letter rather than the spirit of the legislation was limiting the value of disclosures. Another key theme was that a number of new standards are still bedding down and that further regulatory change might be premature.

BIS notes that there is a European Commission on-line consultation on non-financial reporting by companies and the BIS Call for Evidence on a long term focus for Corporate Britain, both of which close during January. In light of these BIS will be developing policy proposals on the corporate governance agenda by Budget 2011 which is scheduled to take place on 23 March 2010.

In the meantime companies are encouraged to consider the best practice guidance set out in the Deloitte publication "Swimming in words – Surveying narrative reporting in annual reports" available from www.deloitte.co.uk.

Date: 22 December 2010

Source: The Department for Business, Innovation and Skills

Further info: <http://www.bis.gov.uk/assets/biscore/business-law/docs/s/10-1318-summary-of-responses-future-narrative-reporting-consultation.pdf>

New clarified auditing standards impose more requirements on auditors

In Brief: Audit committees may be aware that new International Standards on Auditing (ISAs) have been issued which apply to accounting periods ending on or after 15 December 2010. These "clarified" ISAs impose many new requirements on auditors and as a result audit committees will see a change in the scope of audits. Amongst other changes these include:

- Objectives are included for each ISA and there is a need for auditors to determine whether any audit procedures in addition to those required by the ISAs are necessary to achieve those objectives when planning and performing the audit.
- Management override of controls is a presumed "significant" risk which cannot be rebutted.
- Work in relation to related parties is more fraud risk-based and additional audit work is required on transactions which are outside the normal course of business.
- The requirements relating to materiality have changed, in particular a lower amount ("performance materiality") is used when assessing risks of material misstatement and determining the extent of audit procedures to perform.
- Auditors are expected to use confirmation requests more widely to obtain audit evidence.
- There are enhanced documentation requirements such as in relation to significant professional judgements made during the course of the audit and more mandatory procedures when an independent reviewer is required ("engagement quality control reviewer").

- For group audits, greater involvement is required in the work performed by auditors of components of the group, particularly in the identification and response to significant risks. This will result in increased liaison between group and component auditors throughout the audit. There are also more matters that the group auditors are specifically required to communicate to those charged with governance. In addition, component auditors are required to use a lower materiality for their work for group purposes.
- Where misstatements or control deficiencies are identified, if these are to be classed as “anomalies”, further audit work is required.
- There are several new communication requirements such as where significant difficulties are encountered during the audit and there is a clearer definition of what control deficiencies should be communicated to those charged with governance.
- There are more specified procedures in respect of auditing accounting estimates and fair values including audit responses where risks of misstatement are assessed as significant.

Time to take action

- Consider as a board the implications of the FRC proposals on company stewardship.
- Take the opportunity to participate in the ongoing debates on the future of narrative reporting and best practice in risk management. Refer to existing guidance such as the Deloitte publication “Swimming in words” and the publication “Getting it right” as a starting point.
- We urge audit committees to consider carefully the new guidance set out by the FRC on the provision of non audit services and to take advantage of the extended effective date.

On the horizon

- EC Green Paper on corporate governance of listed companies.
- Updated Higgs Guidance.

Date: Apply to accounting periods ending on or after 15 December 2010

Source: Auditing Practices Board

Further info: <http://www.frc.org.uk/apb/publications/isa/oct2009.cfm>

Deloitte refers to one or more of Deloitte Touche Tohmatsu Limited (“DTTL”), a UK private company limited by guarantee, and its network of member firms, each of which is a legally separate and independent entity. Please see www.deloitte.co.uk/about for a detailed description of the legal structure of DTTL and its member firms.

Deloitte LLP is the United Kingdom member firm of DTTL.

This publication has been written in general terms and therefore cannot be relied on to cover specific situations; application of the principles set out will depend upon the particular circumstances involved and we recommend that you obtain professional advice before acting or refraining from acting on any of the contents of this publication. Deloitte LLP would be pleased to advise readers on how to apply the principles set out in this publication to their specific circumstances. Deloitte LLP accepts no duty of care or liability for any loss occasioned to any person acting or refraining from action as a result of any material in this publication.

© 2011 Deloitte LLP. All rights reserved.

Deloitte LLP is a limited liability partnership registered in England and Wales with registered number OC303675 and its registered office at 2 New Street Square, London EC4A 3BZ, United Kingdom. Tel: +44 (0) 20 7936 3000 Fax: +44 (0) 20 7583 1198.

Designed and produced by The Creative Studio at Deloitte, London. 8661A

Member of Deloitte Touche Tohmatsu Limited