

ICAEW Financial Reporting, Audit and Assurance Conference 11 October 2021

A. INTRODUCTION

Firstly can I say thank you for the very kind invitation to come and talk and exchange some views.

My name is Jon Thompson and I am the CEO of the Financial Reporting Council. I'm going to assume that you are all aware of the FRC, its purpose and remit AND the fact that the Government is currently proposing to replace us with a much more powerful regulator called ARGA.

I'm also going to assume that you are aware of the three independent reports – by Sir John Kingman the Chairman of Legal & General, Sir Donald Brydon the Chairman of Sage plc and the review by the Competition & Markets Authority into the audit market. Altogether these three reviews set out the need for significant change in areas relevant to this conference.

Given this is a conference on reporting, audit and assurance, I thought I would cover each of those in turn, reflecting our views on

- the current situation,
- some of our work in those three areas and
- then something about the potential legislative changes you might see in the Government's response to the White Paper, which should be published later in the year.

It is worth remembering that the Purpose of the FRC is to set high standards in corporate reporting, governance and audit and holding to account those responsible for delivering them.

Therefore in reporting, audit and assurance we are striving to higher standards, or, in some areas, more consistent application of those standards, where we see inconsistency and a small minority of players falling well short.

B. REPORTING

Let me start with corporate reporting

We assess the quality of corporate reporting in the UK in three ways

1. through our routine monitoring activities of individual companies of which we conduct around 300 a year,
2. we add to that with thematic reviews (for example last week's review into Alternative Performance Measures) and
3. we publish an overall annual assessment of corporate reporting in November.

Our aim is that disclosures in reports and accounts should be sufficient for users to understand the effect of significant matters on the company's performance, cash flows and financial position.

Across each of the three areas we conduct work our assessment is that the overall quality of reporting by UK companies has remained consistently high in recent years.

In some cases, the most common outcome of our work is that companies enhance the quality of their future disclosures and we see improvement as a result.

And, in a small number of very extreme cases, a handful each year, we have seen immediate clarification by the companies involved.

Overall we have seen improvements over the last few years in certain matters, for example fewer inconsistencies between disclosures relating to judgement and estimation uncertainty in different parts of the annual report and accounts.

However, there is still room for some improvement in specific areas:

1. further explanation of judgements and estimates, and
2. secondly disclosures of impairment testing and impairment losses, for example.
3. We also found scope for better disclosure of revenue recognition.
4. And lastly the statement of cash flows remains the most common source of identified material errors.

In the last year we haven't published very much in terms of changing or amending financial reporting – some minor changes to FRS 101 and FRS 102 and other incremental changes.

But we have published 8 reports setting out best practice in wider corporate reporting, in a number of areas, notably including

- Reporting on risks, uncertainties, opportunities and scenarios

- Reporting to stakeholders under section 172
- Reporting under the Sustainable Accounting Standards Board Standards; and
- Reporting on Going concern, risk and viability as a result of COVID 19

My view, from talking extensively to investors is that they do want more disclosure on a small number of key issues, notably;

1. Risk management in the short and long term
2. Secondly, key accounting assumptions and the aggressiveness, or otherwise, relative to the industry the company is competing in – an area where we continue to have concerns about transparency as highlighted in our last Annual Report on Corporate Reporting and my earlier remarks
3. Thirdly, clear, consistent metrics on the impact of a company on the climate and the environment more generally; and
4. Lastly, clarity from the auditors about how they assessed the key accounting judgements and their aggressiveness, or otherwise. This is also a key audit quality issue where we find auditors consistently fall short.

We heard these requests consistently through the consultation period for the White Paper. They weren't the only requests from investors, but they are my personal view on the main calls for more information.

And of course we should recognize that a longer list of requests from investors was incorporated into Sir Donald Brydon's review, together with a number of related options in the White Paper.

It's worth knowing that the FRC was party to more than 100 events over the 16 week consultation period on the White Paper and I am summarizing a significant number of lengthy comments into a short list for today's speech.

Longer term then, and subject to Ministers and legislation, what changes might be coming in corporate reporting?

I think it's fair to say that the White Paper included a number of potential changes to corporate reporting.

And we heard significant support for many of those proposals, although not universal support for all the reporting changes.

As with all potential legislation the publication of a White Paper was to stimulate further debate and the phase we are now in is to shape the Government's response in what is called the Feedback Statement.

This Feedback Statement will set out those areas the Government is planning to pass primary or secondary legislation, together with what could be delegated to the regulator and what might be dropped altogether. Those are essentially the Government's four options at this stage.

Whilst there is much to still be decided by Ministers, I would expect to see some changes in corporate reporting being proposed, including

1. Stronger supervision of corporate reporting by the regulator, notably including powers on when and how corrections should be made;
2. Secondly, further clarity of the disclosure on distributable profits although probably not as far as some investors called for in their evidence to the Brydon Review
3. Thirdly stronger reporting by companies around their work on the risk of material fraud; and
4. Lastly the introduction of the new Resilience Statement covering short and long term risk, with the regulator empowered to work with colleagues on the nature of additional disclosure to set some minimum new standards

That would address some of the pressure from investors for more information. But not all.

We have to consider what is a proportionate cost to companies of the corporate reporting framework and have been working on areas where corporate reporting might be reduced – or moved into other ways of communicating key public information. Watch this space on that.

Just lastly, in relation to the totemic issue of the impact of a company on the environment, we have been clear for some time that we expect companies to report against the SASB framework and the Government is introducing new reporting obligations against TCFD. Together they should raise the bar considerably.

Our work over the last year highlighted best practice in reporting in this area and we will continue to highlight best practice to help companies

whilst there are ongoing international discussions about standard setting in this area. That is the idea of an equivalent of the IFRS for non-financial reporting where measures and metrics are involved.

And, I am aware that tomorrow this conference will spend the day focusing on sustainability reporting and assurance.

C. ASSURANCE

Let me turn now to assurance where there were major changes set out in the White Paper.

Feedback on this area was very strong with a significant number of responses on key areas such as

1. regulatory oversight of Audit Committees,
2. minimum standards for Audit Committees,
3. the Audit & Assurance Statement and
4. the idea of reporting on internal controls over financial reporting, or a so called UK version of Sarbanes-Oxley.

For those of you who may have read the detail in March, alongside the White Paper, the Government also published its Regulatory Impact Assessment about the cost of the proposals in the White Paper if they were implemented as set out.

I think it's fair to say that there was considerable feedback on the assessed cost of the additional assurance proposals, the most significant of which was the idea of a UK version of Sarbanes Oxley.

I believe that responses to the White Paper showed considerable support for changes to oversight of Audit Committees, minimum standards for Audit Committees and to the introduction of the new Audit & Assurance Statement.

But, I also believe that Ministers will consider very carefully the assessed administrative cost of reporting on internal controls against the benefits of the reforms. At this stage, this change, which some comment as being the most significant in the whole reform package, is still with Ministers to decide on.

In general, I believe that the White Paper has stimulated many Audit Committee Chairs to consider the level of assurance they currently get.

The role of internal audit has certainly been quite prominent in many conversations with us, as has the more general question about the state of internal controls and what assurances can currently be given by management. The Institute of Internal Auditors new standards, published recently, were a helpful reminder of the impact of a quality internal audit function, which we very much support.

Whether Ministers push ahead with legislative change on UK Sox or not, I believe that there is rising interest in assurance, internal control and corporate governance.

And even if legislation is not passed in this area, it would be relatively easy for us to raise the bar further with revisions to the Corporate Governance Code in due course or for us to include reporting on internal controls in any minimum standards for Audit Committees.

D. AUDIT

Let me turn now to audit and start by reiterating that high quality audit is essential to maintaining trust and confidence in the UK's financial markets. If the UK is to retain its position as a world leading professional services marketplace, and a global financial centre, outstanding audit quality and rigorous professionalism is at the heart of this.

You may have seen our annual review in July this year which showed some improvement on last year's results. That improvement is marginal and significant change still needs to happen to meaningfully improve audit quality.

What did happen in our last results was that we saw the improvement programmes of some of the firms beginning to make a difference faster than others, meaning that the spread of results was very wide across the seven largest firms.

Over the last 12 months the FRC has initiated its own programme of measures in response to many of the recommendations in the Kingman review such as:

- initiating operational separation of the Big Four firms prior to legislation and through excellent co-operation and negotiation with the Big 4;
- introducing enhanced audit standards in relation to ethics and fraud; and

- building on our supervisory oversight and strengthening our enforcement capability; this was designed to understand more about what the 7 largest firms are doing to drive up audit quality. Each of the seven largest firms now has a dedicated supervisor that focusses on what the firms are doing to drive up audit quality, how they govern and oversee audit, the introduction of operational separation and the implement of their quality improvement plans amongst other things. That did not exist two years ago.

My expectation is that Ministers will move to implement many of the changes of the White Paper, including

- strengthening the regulators oversight of the audit firms,
- giving legislative backing to operational separation and
- raising the bar further on the fraud obligations on auditors.

In addition, of course changes in the reporting framework feed into the work of the auditors, whose remit should widen as a result of legislative change.

It is our belief that higher standards in companies flows through into higher quality audit and we should see the connection between them.

I'd like to move onto some of the criticism of the FRC that we have never actually said what we think "good audit quality is". And our Audit Quality Reviews don't necessarily serve auditors, or Audit Committee Chairs, well, by building a set of constructive comments which can be rolled out across an audit practice. Nor, by the way, are we transparent as we don't publish our reviews because we don't have the powers to do so.

We plan, therefore, to publish a Framework setting out what we consider to be "good quality audit" and that will be based on evidence we have seen. That Framework is reasonably mature now, not quite ready for publication, but I would expect us to publish something later in the Autumn.

There is, of course, quite a risk that whatever we write down will be patronising and auditors will all say "of course, we knew that" but, nevertheless I remain keen that we do set out our expectations. And, I would say, if auditors knew what we set out then why do they not manage to meet the standards?

Unsurprisingly this Framework does have two distinct sections

1. What are the key attributes of a good audit – that is the conduct of an individual audit; AND
2. What are the attributes of a high quality audit practice

Clearly the second impacts significantly on the first, but we feel it best to separate them as you can have a high quality audit practice but still have isolated incidences of a poor audit.

In the key attributes of a good audit we have split our findings into three groups, covering 19 aspects – the three areas being

1. Risk assessment and planning – including risk assessment, timeliness of planning, responsibilities in relation to fraud, appropriate resources, analytical review, planning group audits and communicating in advance
2. Secondly is execution of the audit – including fieldwork covering the plan, appropriate oversight, proportionality to risk, professional scepticism, use of specialists and recording evidence; and
3. Lastly is completion and reporting – including, unsurprisingly that there is sufficient evidence to support the overall judgement and findings and the quality of the communication of the key matters

I won't go into the 19 aspects in any more detail than at present

On the second dimension of a high quality audit practice we set out 8 areas that we consider together make high quality, including;

1. Practice wide risk management
2. Governance and leadership
3. Monitoring and remediation
4. Quality Monitoring
5. Resource planning and people management
6. Appraisals and reward
7. Audit Methodology and Use of Technology; and
8. Information and Communication

Sorry I don't have more time to set this all out, but hopefully you will find the publication helpful later in the Autumn. I hope it also adds some helpful information from us striving to be an improvement regulator.

In the most expansionist version of the proposals in the White paper there would be more for the auditor to do, with options available to the Audit Committee to extend the work even further.

Potentially that includes auditing areas not currently audited (like aspects of the Annual Report) or going into more depth in some areas (like fraud) or into completely new areas (like internal controls reporting).

All round we await proposals from the Government in this area but I would expect the bar to be raised for auditors.

E. CONCLUSION

Let me conclude by saying there has been some significant change in these areas in the last few years, there are some changes in the pipeline now but there is potentially much more to come once the Government publishes its Feedback Statement at which point you will be able to see the potential legislative changes to come, primary and secondary, the powers of the regulator and what might be dropped from the White Paper.

Thanks for listening.