

Effective company stewardship: enhancing corporate reporting & audit



In the light of the unprecedented stress placed on companies by the financial crisis and global recession, the Financial Reporting Council have issued proposals to enhance the effectiveness of the stewardship role of boards and audit committees through corporate reporting and audit.

Following enquiries into the lessons to be learned about governance from the financial crisis the FRC revised the UK Corporate Governance Code (the "Code") and issued the Stewardship Code for Institutional Shareholders. It has also issued guidance to auditors on assessing whether a business is a going concern, on audit firms' governance and on auditor independence.

However, the FRC believe that there is more to do. The financial crisis highlighted the importance of the identification, analysis and management of risk. That is not only true in financial services. Companies in all sectors still get into trouble because of failures in this respect and the FRC hope to reduce the likelihood that the message will be forgotten – as it has been after past crises – by increasing transparency in the way that directors' report on their activities, including their management of risk.

The proposals, set out in the paper *'Effective Company Stewardship: Enhancing Corporate Reporting and Audit'*, include measures designed to:

- improve narrative reporting (particularly on business strategy and risk management);

- engender widespread recognition of the importance of audit committees and their contribution to the integrity of financial reporting;
- increase transparency with respect to how audit committees discharge their responsibilities;
- provide both audit committees and investors with more information about the audit process;
- broaden the scope of the auditor's responsibilities; and
- enhance the accessibility of annual reports through the use of technology.

Narrative reporting

The FRC set out that the narrative report, like the financial statements, should reflect a Board's considered view of the information that investors and other users of annual reports need. It should not be promotional in nature, a fault seen in some narrative reporting.

To achieve this, the FRC believes that an annual report should explain, in a manner that is clear and understandable to users, the company's business, strategy and prospects and the risks and uncertainties involved in the course being pursued. Directors should be responsible for ensuring that each element of an annual report, as well as the annual report in

aggregate, should meet the test of being balanced and fair. The role of the auditor in relation to this is addressed below.

The FRC go on to say that if users are to have confidence in directors' stewardship, companies should explain the steps that they take to ensure the reliability of the information on which the management of a company is based. Any such explanation should include matters such as:

- the principles on which the internal reporting regime, particularly in relation to the principal risks arising from the company's activities, is based;
- the steps taken to establish a clear framework of management and reporting, under which specific individuals have responsibility for particular aspects of the company's activities;
- the role of internal audit;
- the extent and frequency with which the effectiveness of the system is tested; and
- the effectiveness of the external assurance arrangements.

The FRC also recommend that companies should take advantage of technological developments, such as XBRL, to increase the accessibility of the annual report and its components.

Extended audit scope

The FRC propose that the standards governing the provision of reports by auditors to audit committees (such as ISA (UK & Ireland) 720) should be enhanced to ensure that they provide the information that is necessary to enable committees to understand fully the factors that auditors have relied upon in exercising their professional judgement in the course of the audit and, in particular, in reaching their audit opinion. These are likely to include, at a minimum, the auditors' views on:

- the effectiveness of the company's controls (including their assessment of the risks arising from the company's business model) and how they have been tested, including the extent of the testing undertaken by the auditors as part of their agreed audit process;
- the judgements made in the audit plan about what is of material significance and the implications of those judgements for the level of assurance provided by the audit;
- the appropriateness of the accounting policies (viewed individually and in aggregate);
- the valuations of the company's assets and liabilities provided by management (with particular reference to those that are significant to the financial statements); and
- any other matters identified in the audit plan or by the audit committee as material to the proper presentation of the company's financial position.

In the FRC's view, greater awareness of such matters would have four benefits. First, the discipline of providing such reports should enhance the quality of the auditor's exercise of professional judgement. Secondly, it would increase the transparency of the audit process to the audit committee. Thirdly, it would help the audit committee form its own view of the appropriateness of the presentation of the company's financial performance in the financial statements. And, fourthly, it would provide important information to the audit committee when deciding what information to include in its own report (see 'Audit committee reporting').

Audit committee reporting

The FRC propose that audit committees report on the approach they have taken in discharging their responsibilities, including describing in such terms as they consider appropriate (having regard to the commercial interests of the company concerned):

- the key areas of sensitivity or risk, including the choice of accounting policies, and how they arranged for them to be addressed;
- any matters of material significance identified by the auditors in their report to the audit committee that are not addressed elsewhere in the annual report and which, in the directors' view, should be known to users if the annual report, taken as a whole, is to be fair and balanced;
- the steps taken by the audit committee to assess the effectiveness of the audit;
- the policies adopted by the audit committee in relation to the provision of non-audit services;
- the process by which the committee reached their recommendation to appoint or reappoint the company's external auditors and the reasons for that recommendation; and
- the nature of any dialogue with investors in relation to any material audit related issues (not covered elsewhere in their report).

Such a report by the audit committee would support the confirmation by the board that the annual report properly and fairly describes the business and its financial performance.

Expanded audit reports

If the above proposals relating to audit committees reporting on how they have discharged their responsibilities are implemented, the FRC propose that auditors be required to report on the completeness and reasonableness of such reports and, if necessary, set out any further related information. That would assure users that they had been provided with a comprehensive report on the matters that the auditors considered important in the course of their audit and in reaching their audit opinion.

A further area where the FRC believe auditors can provide a measure of assurance relates to those matters, other than the financial statements, contained elsewhere in the annual report. For the reasons discussed above, it would not be appropriate to require auditors to provide a separate report on such matters – but there is no reason why they should not be required to report, based on the work that they have done in the course of their audit, whether they are aware of any facts or matters in the annual report that are incorrect or inconsistent with the information contained in the financial statements or obtained in the course of their audit.

Investor involvement in the appointment of auditors

The FRC believe that there is a case for the independence of the auditor appointment decision to be reinforced by the audit committee seeking greater shareholder involvement. In such an approach audit committees should be required either:

- to report on the process by which the committee reached their recommendation to appoint or re-appoint the company's external auditors and the reasons for their recommendation; or
- to discuss with a number of principal investors the approach to be taken to the appointment or re-appointment of the auditor, including the merits or otherwise of putting the audit out to tender and then report on that consultation to shareholders generally.

If you would like further information on any of the matters discussed above, please talk to your usual KPMG contact or contact:

Timothy Copnell
020 7694 8082
tim.copnell@kpmg.co.uk

The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavour to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act on such information without appropriate professional advice after a thorough examination of the particular situation.

© 2011 KPMG LLP, a UK limited liability partnership, is a subsidiary of KPMG Europe LLP and a member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative, a Swiss entity. All rights reserved. Printed in the United Kingdom.

The KPMG name, logo and "cutting through complexity" are registered trademarks or trademarks of KPMG International. KPMG LLP (U.K.)'s Design Services | RRD-247228 | January 2011