Response from
The Institute of Chartered Accountants of Scotland to the Financial Reporting Council

Effective Company Stewardship: Enhancing Corporate Reporting and Audit

30 March 2011
INTRODUCTION

The Institute’s Audit and Assurance Committee has considered the discussion paper *Effective Company Stewardship: Enhancing Corporate Reporting and Audit* and is pleased to forward its comments to the Financial Reporting Council (FRC).

The Institute is the first incorporated professional accountancy body in the world. The Institute’s Charter requires the Audit and Assurance Committee to act primarily in the public interest, and our responses to consultations are therefore intended to place the general public interest first. Our Charter also requires us to represent our members’ views and protect their interests, but in the rare cases where these are at odds with the public interest, it is the public interest which must be paramount.

In December ICAS published its own report *The Future of Assurance*. Our recommendations for the future of corporate reporting and assurance are the product of a working group comprising members from across the stakeholder spectrum – including investors, audit committee chairs, preparers and auditors. Our working group also included observers from the FRC and the Financial Services Authority (FSA).

We are pleased to see many of the recommendations of our working group mirrored in this discussion paper and we believe the ICAS publication both complements and enhances the thoughts of the FRC. Annex B shows a side by side comparison of the FRC proposals against our own recommendations. A copy of *The Future of Assurance* is attached to this response.

Annex B contains our detailed comments on specific aspects of the discussion paper.

KEY ISSUES

Consistent Aims
We believe that the aims of the FRC stated on Page 5 of the discussion paper are consistent with the ICAS Vision set out on Page 9 of *The Future of Assurance*. Fundamentally both reports are premised on the idea that increased transparency will lead to better information for the capital markets. We are pleased to see that the FRC have addressed the corporate reporting model and the role of the audit committee in the overall assurance process.

Engagement of Shareholders
A fundamental premise of both our own report and the FRC discussion paper is an assumption that shareholders are willing to engage with companies in relation to the audit process. We have proposed an addition to the FRC *Stewardship Code* – a principle that institutional investors should be willing to engage with their investee companies on the quality of their reporting and the assurance provided on that reporting. We strongly urge the FRC to consider this revision to the *Stewardship Code*. 
Additional Assurance

Our own report proposed a separate assurance opinion delivered by the external auditors on the narrative section of the annual report. We proposed that this should mirror the sign-off by the Board that the annual report is “balanced and reasonable”. We believe that this opinion is understandable to the user and provides the desired assurance that the annual report is not subject to “spin” by management. We believe that this additional assurance can be delivered with only an incremental increase in the workload of the external auditors, utilising the auditor’s existing knowledge and understanding of the business.

The FRC’s proposal to require the auditors to identify any matters in the Annual Report that they believe are “incorrect or inconsistent with the information contained in the financial statements or obtained in the course of their audit” risks both increasing the current expectations gap and significantly inflating the cost of an audit. The use of the word “incorrect” implies a high degree of accuracy which would require substantial additional work by the auditor – and in some instances would not be possible due to the forward-looking nature of the narrative information. Users need to understand the limits of an assurance opinion and the use of the term “incorrect” could lead to expectations that the degree of assurance is higher than intended.
ANNEX A: SPECIFIC COMMENTS ON THE DISCUSSION PAPER

NARRATIVE REPORTING

There is a risk that the requirement for the directors to disclose the steps they have taken to produce a fair and balanced report will simply result in boilerplate disclosures of processes. Our own report recommends that the Board should focus on “telling the story” of the business. The audit committee report should provide the detail the user requires to understand the governance of the company.

“Fair and Reasonable”
The FRC have chosen to require directors to sign off that the annual report is “fair and reasonable”. We believe that the intention is very similar to our own recommendation that the Board should sign off that the annual report is “balanced and reasonable”. However we believe that the use of the word “fair” could be confused with the “true and fair” opinion given on the financial statements – and therefore the use of the word could imply a higher degree of accuracy to the annual report than the auditor is capable of assuring. We believe that “balanced and reasonable” is more easily understood and gives a clearer distinction from the “true and fair” opinion on the financial statements.

ASSURING INTEGRITY

Scepticism
We believe that the FRC needs to elaborate on how audit work could have been more “effective” if auditors had been more sceptical – particularly when there are no examples provided of instances where financial statements were materially misstated. Scepticism has been central to a number of discussion papers and consultations – including those from the FRC, the FSA and the European Commission – yet there is a consistent lack of evidence presented to support the assertion that auditors have not been sufficiently sceptical. We accept that it can be difficult to assess and report on the levels of scepticism applied by auditors but the FRC needs to be able to justify its reasoning that auditors should have been more sceptical.

Revision of International Standards on Auditing (ISAs)
The discussion paper proposes revisions to the ISAs governing reporting by the auditors to audit committees. ISA 260 and ISA 265 already require a number of these matters to be reported to the audit committee – for example ISA 260 requires the auditor to communicate to those charged with governance: “The auditor’s views about significant qualitative aspects of the entity’s accounting practices, including accounting policies, accounting estimates and financial statement disclosures.” The International Auditing and Assurance Standards Board (IAASB) has only recently concluded its Clarity Project – a project which the Auditing Practices Board was involved with – and we would urge the FRC to consider carefully whether the proposed revisions to the ISAs are actually necessary.
The most significant of the FRC’s proposed revisions to the ISAs is the proposal to require auditors to report to audit committees on “the effectiveness of the company’s controls” and how those controls have been tested. Auditors perform a risk assessment of a company’s control to determine which controls they can rely on for audit purposes and they will very rarely place reliance on all financial controls in place in a company. It is not clear whether the FRC intends that the auditors should report on the effectiveness of all the company’s controls or only those which the auditor has chosen to rely on. If the proposal is for the former then this will involve significant additional work for the auditors and cost to the company.

**Co-operation Between Regulators and Auditors**

The discussion paper correctly notes that there needs to be a strengthening of the lines of communication between the regulators and the auditors. It should, however, be stressed that any duty on the auditor to report certain matters to the regulator should be mirrored by a reciprocal obligation on the regulator to provide certain information to the auditors.

**Audit Committee Report**

The discussion paper proposes that the audit committee should report on “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…” In contrast, our own proposal was to require that the audit committee report on the “key areas discussed between the audit committee and external auditors, including the main areas of audit challenge”. We believe that our proposal would result in increased understanding of the audit process. If the audit committee report is to be the vehicle for increased transparency, it is not helpful to continue to have information buried in various places in the annual report.

**Appointment of Auditors**

We note that the FRC proposes that the audit committee disclose the process by which they decided to appoint or reappoint the auditors and the nature of the decision. We would urge the FRC to consider our proposal of requiring that the audit committee disclose their policy on how frequently they plan to tender the audit appointment. The audit committee should then comply with its policy or explain why it has chosen not to. A “comply or explain” approach allows the audit committee the flexibility of choosing not to tender when it is impractical to do so – for example when the company is going through a period of restructuring. We believe that our proposal would significantly increase the transparency of the process of providing investors with a basis on which to challenge the appointment of the auditors if necessary.

We have also proposed that the audit committee should perform a detailed review of the effectiveness of the auditors (in addition to the annual review) through which they should engage with shareholders – and then disclose details of this process in their report. We believe that this, together with the additional proposed principle for the Stewardship Code, could improve the engagement between audit committees and investors.

**FOSTERING QUALITY IMPROVEMENTS**

We support the discussion paper’s suggestion of extending the remit of the Financial Reporting Review Panel (FRRP) to cover the whole of the narrative content of the annual report. However, we would strongly urge the FRC to ensure that the membership of the FRRP is suitable for its extended role. Its current focus is primarily on technical financial reporting issues and its membership reflects this role.
We note that the FRC are also proposing a market practitioner's forum and a “financial reporting lab”. While we support the intention of the FRC to promote best practice we are not convinced that creating additional structures within the FRC itself is the most effective method of achieving this goal.
## ANNEX B: COMPARISON OF FRC DISCUSSION PAPER EFFECTIVE COMPANY STEWARDSHIP AND ICAS REPORT THE FUTURE OF ASSURANCE

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<th>FRC Effective Company Stewardship Proposal</th>
<th>ICAS Future of Assurance Proposal</th>
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<td><strong>AIMS OF FRC</strong></td>
<td><strong>VISION OF ICAS</strong></td>
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<td>- Higher quality narrative reporting, particularly on business strategy and risk management;</td>
<td>- The corporate report forming the basis of a constructive dialogue between the stakeholder and the company. The report would no longer be boilerplate and the Board would tell a balanced and coherent story of the business – including the business model, strategy, key risks, assumptions and future prospects;</td>
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<td>- More widespread recognition of the importance of audit committees and, therefore, greater emphasis on their contribution to the integrity of financial reporting;</td>
<td>- The audit committee’s role strengthened further through increased disclosure and transparency and the audit committee report becoming the primary vehicle for delivering visibility of the assurance processes – both internal and external;</td>
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<td>- 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;</td>
<td>- In addition to the current audit opinion, the auditor would provide a separate “balanced and reasonable” opinion on the front half of the annual report. The auditor would also explicitly refer to the going concern review and the content of the audit committee report (which would include the key areas discussed between the audit committee and the external auditors). All opinions would be delivered in one assurance report.</td>
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<td>- 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</td>
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<td>- More accessible annual reports through the use of technology.</td>
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<td>Directors should take responsibility for ensuring that an Annual Report, viewed as a whole, provides a fair and balanced report on their stewardship of the business.</td>
<td>The narrative in the annual report should tell a clear, logical and understandable “story” of the business, presenting a balanced and reasonable picture of the company, and should include an explicit sign-off by the Board that the narrative represents a balanced and reasonable review of the company.</td>
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<td>Directors should describe in more detail the steps they take to ensure:</td>
<td>The annual report should include the rationale for why the Board believes that the company is going concern (possibly extending going concern beyond 12 months if appropriate), including:</td>
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<td>- The reliability of the information on which the management of a company, and therefore directors’ stewardship of the company, is based;</td>
<td>- Disclosure of the key assumptions on which the rationale is based;</td>
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<td>- Transparency about the activities of the business and any associated risks.</td>
<td>- A clear exposition of the business model and the strategy;</td>
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<td>Companies should provide information in their Annual Report on:</td>
<td>- An articulation of the key risks facing the business (reflecting the risk discussions of the</td>
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risks, 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 the frequency with which the effectiveness of the system of internal control is tested; and
- The effectiveness of the external assurance arrangements.

Companies should take advantage of technological developments to increase the accessibility of the annual report and its components.

### THE AUDIT

The revision of auditing standards to expand the nature and extent of the report provided by auditors to audit committees.

An expanded audit report that includes:
- A separate new section on the completeness and reasonableness of the audit committee report; and
- Identification of 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.
- There should be greater investor involvement in the process by which auditors are appointed.

The report to the audit committee should include:
- The effectiveness of the company’s controls and how they have been tested, including the extent of the testing undertaken by the auditors as part of the 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;
- Their overall conclusions on the valuations of the company’s assets and liabilities provided by management, in particular those significant to the financial statements;
- Any other matters identified in the audit plans or by the audit committee as material to the proper presentation of the company’s financial position.

### THE AUDIT

A single audit report which follows the sign off by the Board that the accounts and true and fair and the narrative “balanced and reasonable”.

The single audit report would include:-
- An opinion on whether the accounts are true and fair and properly prepared;
- An opinion on whether the annual report is consistent with the financial statements;
- An opinion that the going concern assessment is reasonable;
- An opinion that the annual report is “balanced and reasonable”; and
- A reference to the audit committee report (see below) confirming that the report is an appropriate reflection of the disclosure of the discussions between the audit committee and the auditor.

We have not proposed an additional report to the audit committee over and above that currently produced under International Standard on Auditing (ISA) 260 and ISA 265. A report prepared according to those standards would normally include the vast majority of the information proposed by the FRC and the audit committee are free to challenge the auditors to provide additional information if they require it.

It should however be noted that a report on the “effectiveness of the company’s controls” would require significant additional work effort and therefore cost from the auditors. Auditors only test controls they are intending to rely on for the purposes of their audit and therefore would not
normally test all controls (which can be a very burdensome and time consuming task depending on the nature of the control). This proposal would need to be clarified to ensure that the auditors would only need to report on those controls they have chosen to rely on.

**THE AUDIT COMMITTEE**

The audit committee should report “on the approach that they have taken to the discharge of 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, that they identified to the integrity of the Annual Report, including the financial statements, and how they arranged for those 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 that they took to assess the effectiveness of the audit;
- The policies that they adopted in relation to the provision of non-audit services to avoid the independence of the company's auditors being compromised;
- The process by which they reached their recommendation to appoint or re-appoint (as the case may be) the company's external auditors and the reasons for that recommendation; and
- The nature of any dialogue that they may have had with investors in relation to any material audit related issues (not covered elsewhere in their report).

In relation to the appointment of the auditors the audit committee should either:
- report on the process by which they reached their recommendation to appoint or re-appoint (as the case may be) 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 of its auditors, including the merits or otherwise of putting its audit out to tender and

**THE AUDIT COMMITTEE**

The audit committee should report on the following:

In relation to risk management:
- Confirmation it has received sufficient, reliable and timely information from management to allow it to discharge its duties;
- How it has satisfied itself that the risk and control processes are operating effectively. This should include a matrix-style report which maps the key risks disclosed by the Board in the corporate report to the assurance processes used to gain comfort over those risks;
- Confirmation that action has been taken where appropriate to address any significant weaknesses in the risk and control framework;
- How it satisfied itself of the appropriateness of management’s significant judgements (for example how the audit committee satisfied itself that the models used to value financial instruments are appropriate or how it determined that the value of a decommissioning provision was a reliable estimate of the costs).

In relation to the audit appointment:
- The date the audit firm was first appointed as the external auditor;
- The date the external audit appointment was last subject to a full tendering process;
- The policy on the expected timescale after which the company would normally expect to re-tender the audit appointment;
- Where the auditor has been subject to the normal annual review of effectiveness – the process by which the audit committee concluded that the external audit was effective or otherwise and the conclusions of that review;
- Where the auditor has been subject to the extended 5 yearly review process – the process by which the audit committee concluded that the external auditor was effective or otherwise, in particular how it engaged with the shareholders during this process; and the
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- The reason for any decision to re-tender the audit other than simply compliance with the policy;  
- The circumstances of any resignation or dismissal of the external auditor before the end of their term. |

In relation to the external audit process the audit committee report should include:  
- Details of the key areas discussed between the audit committee and the external auditor during the audit process, including the main areas of audit challenge.

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<td>The FRC have stated that they would support some form of safe harbour defence to directors and auditors in relation to forward-looking information.</td>
<td>We have stated that we believe there is a need to consider safe harbours for directors and proportionate liability for auditors.</td>
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- In the event of a corporate failure a review can be carried out of the company's governance, accounts and audit.  
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