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Looking ahead: What you need to know Spring 2017

The 100 Group briefing

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Dear members of The 100 Group,

Welcome to the second edition of the 100 Group briefing for 2017.

As we approach the Easter holidays, the Government's Green paper on Corporate governance continues to stand at the forefront of current affairs. Although BEIS has yet to publish all responses gathered, we've included our analysis of high-profile responses so far. Themes are already emerging which are likely to influence policymakers. We're expecting some significant changes as a result.

This edition also includes our summary of a number of thematic reviews released by the FRC concerning reporting and assurance matters. Group members are advised to pay close attention to the areas identified by the FRC as failure to take action will no doubt lead to more definitive action by the FRC.

You'll also read an analysis of our recently released 2017 Global Investor Survey. The survey itself, linked in this document, is also worthy of a read to find areas of common ground for dialogue with the investment community.

We've set out in the Executive summary the other topics included in this edition. I hope you find the briefing useful – please do let me know what you'd like to see more of and how we can improve the publication.

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Looking ahead

The 100 Group briefing, *Looking ahead*, is a quarterly briefing commissioned by the 100 Group of Finance Directors. Its aim is to brief the group on key developments in the capital markets and proposed changes in regulation and standards that might require response, lobbying, or which are important for general awareness.

For further information, please contact Gilly Lord.

Executive summary

Key: M – Monitor R – Respond/React L – Lobby

Reporting

FRC thematic review on tax disclosures

Late last year the FRC announced a thematic review into tax disclosures with an aim of improving reporting of the relationship between tax charges and accounting profit, as well as factors that could impact this in the future. PwC's Peter Hogarth looks at the outcome.

The tax reporting of 33 FTSE 350 companies was reviewed and the FRC has published a report on its findings with best practice examples of tax disclosures. The FRC noted that the announcement of the review encouraged better reporting of tax in general and there was some evidence of greater visibility of the factors influencing tax rates and their sustainability. However, the FRC considers that there remains scope for companies to better articulate how they account for tax uncertainties and to disclose the amounts subject to risk of material change in the following year. It was highlighted that none of the FTSE 100 companies reviewed stood out as a role model for their tax reporting.

The review's findings focus on the discussion of tax in the strategic report, the quality of effective tax rate (ETR) reconciliations, and the transparency in relation to uncertain tax positions (UTPs).

ETR reconciliation

Best practice examples of ETR reconciliations were those where reconciling items were clearly disaggregated, avoided significant netting, and included detailed narrative of the nature and amount of the item, including information as to why disallowable expenses, non-taxable income and permanent differences are not tax deductible or chargeable.

Information relating to the future sustainability of these relationships is also important and can be achieved through separately identifying recurring and non-recurring items or disclosing factors that may lead to changes going forward, such as new challenges from tax authorities, law changes, rate changes, timing of recognition of tax losses, impact of acquisitions/disposals and the ability to continue certain arrangements or structures.

Significant judgements and estimation uncertainty in relation to UTPs

The FRC expects that companies with UTPs should be disclosing their recognition criteria, measurement methodology and factors considered in determining provisions in detail as part of their policy, avoiding boilerplate language. The IASB are shortly expected to clarify the requirements and the FRC note that this presents companies with an opportunity to further improve the quality of their reporting.

It was noted that only 45% of the companies reviewed quantified their uncertain tax provisions. The FRC will expect that companies stating that UTPs are an area of significant judgement in their audit committee disclosures or accounting policies will disclose the value of their provisions subject to risk of material change in the following year.

Where there is estimation uncertainty, companies should disclose the specific nature of the uncertainty, the assumptions made and provide sensitivity analysis or ranges so that users can understand how the tax charge may vary in the future. This equally applies to contingent tax liabilities given they arise from the same processes. The FRC will challenge uncertainties that are repeatedly rolled-forward as in their view it does not help the user quantify the short-term risks and distinguish them from other valuable information about medium-term tax risks and specific judgements.

The FRC's thematic review provides a benchmark for the expected standard of reporting on tax and failure to meet these standards is likely to be subject to detailed future challenge by the FRC.

FRC's 2017/18 thematic reviews

The FRC has announced that it will undertake thematic reviews of certain aspects of corporate reporting. PwC's Peter Hogarth looks at the areas involved.

The Financial Reporting Council (FRC) has announced it will, in 2017, undertake thematic reviews of certain aspects of companies' corporate reports where it believes there is scope for improvement and particular shareholder interest.

The FRC has already written to a number of companies prior to their year-end informing them that it will review disclosures in their next published reports, specifying the topic it will be reviewing. The aim of this monitoring activity is to drive continuous improvement in the quality of corporate reporting and to identify good examples of clear and concise disclosures. The FRC will then share these good examples to help others raise the quality of their reporting.

The thematic review topics are:

- Alternative Performance Measures (APMs).
- Pension disclosures.
- Significant accounting judgments and sources of estimation uncertainty.

Below I've briefly laid out some context and what the FRC will be looking at in each review.

Alternative Performance Measures (APMs)

The FRC has already conducted a limited thematic review into the use of APMs in interim statements for periods ended 30 June 2016. The forthcoming thematic review will focus on matters that gave cause for concern in the first review and any matters noted in the FRC's *Annual Review of Corporate Reporting 2015/2016* published in October 2016. It will consider the extent to which the reports and accounts are consistent with the European Securities Markets Authority's (ESMA) 'Guidelines on APMs' and will likely question any material inconsistencies.

The FRC has identified specific areas where it believes that improvements can be made and expects the following:

- Good explanations to be given supporting the use of particular APMs; why they are useful, helpful or more meaningful rather than simply asserting that this is the case or that they are used internally.
- Where an APM is used internally, why it is so used, by whom and for what purpose; for example, if it relates to measures used for directors' remuneration.
- The narrative in strategic reports to give no greater emphasis to APMs or proforma information prepared on a non-IFRS basis than the discussion of the IFRS results. The Guidelines state that APMs should not be displayed with more prominence, emphasis or authority than measures directly stemming from the financial statements.
- Definitions of APMs to be presented for each APM together with reconciliations to IFRS equivalents, which can be by way of cross-reference to definitions or reconciliations.
- Companies to explain why an APM definition has changed compared to the previous year.
- Companies to be clear about when a measure is an APM, for example, not referring to 'profit before tax' when the amount shown is actually calculated on a non-IFRS basis.
- Companies to consider carefully when they give long lists of items which are excluded from adjusted profit (or similar measures) and, in particular, to consider whether all such items are properly excluded; for example, 'non-recurring' restructuring costs that appear to recur, share-based payments or legal costs.

Pension disclosures

Pension disclosures are important to help users understand the significant factors that could impact the future pension expense and cash flows of the company, as well as the security of future payments to pensioners.

The FRC has identified the following specific areas where improvements can be made and expects the following:

- Quantified information about the level of funding of the pension scheme expected in future years.
- The risks inherent in the investment strategy to be clearly identified and explained; for example, when this involves the use of complex financial instruments.
- Where net pension assets (plan surpluses) have to be considered, the basis on which the company expects to benefit, including the judgments made when assessing trustee rights.
- An explanation of how fair value has been determined for assets such as insurance contracts or longevity derivatives.

Significant accounting judgements and sources of estimation uncertainty

Paragraphs 122 to 129 of IAS 1 require the disclosure of judgements and estimates made by management that have the most significant effect on the amounts recognised in the financial statements. Many disclosures are often generic. This makes it difficult for readers to understand the specific judgments made or understand why estimates are uncertain and how changes in values of assets and liabilities could have a material impact on the following year's financial statements.

The FRC has identified the following specific areas where improvements can be made:

- Clear descriptions of the specific, material judgements made by the directors in applying accounting policies, clearly differentiating these from estimates.
- Specific identification of the sources of estimation uncertainty that have the potential to change in the next year, with quantified explanations of the assumptions made about the future, for example, oil prices, and the carrying amounts that are subject to a significant risk of material adjustment within the next financial year.
- Where material, supplementary disclosures such as information about the sensitivity of estimates to changes in assumptions, the range of reasonably possible outcomes and changes made to past assumptions during the year.

Group members would be advised to pay close attention to the areas identified in the FRC's thematic reviews. Even for those companies not involved in the thematic reviews, they give a clear insight into which sections of the annual report the FRC's Corporate Reporting Review Team will be most interested in.

Non-financial reporting regulations

In December 2016, Non-financial reporting regulations ("the regulations") came into force in the UK, requiring large Public Interest Entities with more than 500 employees on average in a financial year (unless they are exempt) to include a non-financial information statement in their strategic report for periods beginning on or after 1st January 2017. PwC's Sarah Allen looks at what they mean for those affected.

These regulations may have been dismissed as tinkering by many, given their apparent similarity to the existing strategic report regulations. However, with the recent Government Green paper on governance reform proposing greater accountability of stakeholder interests in reporting, it is clear that the importance of reporting non-financial information is increasing.

How the non-financial information regulations will interact with the current strategic report requirements requires some clarification and the FRC will be issuing a communication to help companies with implementation shortly. The box below summarises the new requirements:

Contents of the non-financial statement

The non-financial information statement must contain information, to the extent necessary for an understanding of the company's development, performance, position, and the impact of its activity, relating to, as a minimum:

a) environmental matters (including the impact of the company's business on the environment)
b) the company's employees
c) social matters
d) respect for human rights
e) anti-corruption and anti-bribery matters.

If any of the required content is excluded, the statement must provide a clear and reasoned explanation.

We have identified the following key differences from existing requirements:

1. **Anti-corruption and anti-bribery matters** – While anti-corruption and anti-bribery matters have not previously been required to be disclosed in a company's annual report, it's probably not surprising that it has been added to the list of matters companies should report on when considering the potential impact it can have on a business. The extent to which this is relevant for a company is expected to vary depending on where and in what industries the business operates, but is likely to be an area of consideration for most companies.

2. **The impact of activities** – The current strategic report regulations only explicitly include a requirement to consider the impact of the company's business on the environment. This is consistent with Section 172 of the Companies Act 2006 which states that Directors should have regard to the impact of the company's operations on the community and the environment. The requirement to report on the impact of a company's activity on all other areas covered by the non-financial regulations is therefore a notable additional reporting requirement. While the definition of "impact" requires some clarification, companies will need to consider how they might report on how their operations can positively contribute to and adversely impact upon the matters required by the non-financial reporting regulations as listed above. The regulations also require a description of the business relationships, products and services that are likely to cause adverse impacts in relation to the principal risks relating to the matters listed above.

3. **Policies and due diligence processes** – The existing strategic report regulations require disclosure of information about any policies in relation to the matters above and the effectiveness of those policies (with the exception of anti-corruption and anti-bribery). The non-financial reporting regulations introduce a new requirement to describe any due diligence processes implemented by the company in pursuit of those policies. While the FRC's Guidance on the Strategic Report recommends that any process of due diligence could be included in the strategic report, this was not previously specified in the regulations.

What's interesting is how the new non-financial regulations now mandate certain disclosures that were previously just guidance. To consider what impact this might have, we have performed a high-level review of existing reporting practices to see how well companies were reporting against the strategic report regulations and FRC guidance. From a sample of FTSE 350 companies two overarching themes emerged:

1. Updates will be required to the majority of strategic reports to address the new requirements. For example, to address the requirement to discuss anti-corruption and anti-bribery matters.

2. It is not always clear how the existing reporting requirements are being met as key messages are often boilerplate and buried in the narrative. Improvements in the quality of reporting would help to identify how the existing strategic report requirements are being met and provide further insight into non-financial matters.

We recognise a lot of the non-financial reporting regulations are not new and many companies will already be reporting something in these areas. But, our analysis shows they cannot be disregarded. At the very least we would encourage Group members to get comfortable with the subtle differences in requirements and identify possible gaps in their disclosure or opportunities for improvement. With the spotlight firmly on stakeholder accountability, it's better to be prepared than exposed as undoubtedly this regulation will raise the bar on the quality of non-financial reporting.

Corporate governance

Green Paper on Corporate Governance

It's possible to see patterns emerging across all three strands of the Government's proposals, says PwC's John Patterson.

Whilst the responses to the Government's Green Paper on Corporate Governance Reform have to date not been collated on the BEIS website, a number of common themes can be drawn from those that have been published elsewhere, as well as some interesting additional suggestions. The FRC response is available and is highly significant, given that much of what is proposed in the Green Paper would fall to the FRC to implement. We therefore consider below the key messages for companies from the FRC's response in each of the three thematic areas in the Green Paper and reflect too on some of the views of a range of other influential respondents.

The FRC adds a fourth strand to the three themes that BEIS identified, concerning effective enforcement of existing law. In particular, it calls for its remit to be extended in two key areas: to allow it to take action against directors who are neither accountants nor actuaries; and to monitor the quality of the corporate governance section of the annual report.

Respondents' views on main themes in the Green Paper

Executive pay

On the question of whether there should be ***stronger powers for shareholders to hold companies to account***, there is a general sense from a number of respondents that it is still early days for the reporting and voting requirements that were introduced in 2013; many companies are only now having the second binding vote on their remuneration policy. The Investment Association and CBI urge the focus to be mainly on the relatively small number of companies that receive a significant vote against their remuneration arrangements (there were only six in 2016). Consistent with this, the FRC recommends strengthened reporting requirements in such cases and a system of both escalation and acceleration of voting, particularly where significant votes against have recurred. Both the Investment Association and CBI go into detail on how this could work, with the Investment Association suggesting that the remuneration policy should be brought back to shareholders within 12 months if the annual remuneration report gets less than 75% support, or within six months if it gets less than 50%.

The FRC proposes that the ***role of the remuneration committee*** should be widened beyond board-level pay to "policies and procedures throughout the organisation and the behaviours they drive". There is also widespread support for the suggestion that the chairman of the remuneration committee should be a member of the committee for at least twelve months before taking up that post.

On ***transparency***, there is general support for the suggested new ***pay ratio disclosures***, and the Investment Association suggests that these should address the CEO to executive team ratio, as well as CEO to median employee. It is recognised that the detail of these ratios will need to be worked through and that contextual commentary around the numerical disclosures will be important; the CBI urges a focus on UK employees specifically. The Investment Association response reiterates their existing recommendation, picked up in the Green Paper, to reduce the flexibility that the existing regulations allow on the ***disclosure of bonus targets***, and for greater clarity to be established around the use of the 'commercial sensitivity' exemption.

Finally on executive pay, no clear preferences seem to be emerging on the question of whether ***long-term incentive plans*** could be ***better aligned with shareholders' and companies' interests*** other than general support for retaining flexibility and doubt as to whether restricted share awards are a solution in themselves (as they can undermine the pay for performance link).

Strengthening the employee, customer and wider stakeholder voice

The Green Paper proposes a number of options designed to build confidence that directors are carrying out their duties to promote the success of the company using the "enlightened shareholder value" approach set out in s172 of the Companies Act 2006 ('s172') by having regard to other stakeholders when making decisions.

There is general agreement among respondents that s172 is fit for purpose, but that there needs to be greater awareness of it. The FRC, in its response, makes a number of proposals to enhance ***reporting*** including:

- a new requirement for a formal statement by directors as to how they have carried out their duties under s172 to be incorporated into the Companies Act requirements for content of the Strategic Report
- related revisions to the FRC Guidance on the Strategic Report.

The FRC also proposes new reporting on how the directors have "allocated value" between, for instance, pensions, dividends, remuneration, research and development and capital expenditure, which may reflect their consideration of wider stakeholders (it is interesting that the House of Commons Work and Pensions Committee response recommends adding pension scheme beneficiaries and trustees to the stakeholders listed in s172). The FRC also suggests a revision to the UK Corporate Governance Code ('the Code') provision on viability statements which could have companies and boards "explicitly consider long term obligations", as so many statements in year one of viability reporting were clustered around a relatively short three to five year time period.

In relation to the main ***procedural options*** set out in the Green Paper (stakeholder advisory panels, designated non-executives responsible for representing stakeholder views, and stakeholder representatives on boards), the FRC believes it will be best to incorporate into the Code "a small range of options allowing for flexibility and innovation" but stops short of being more specific (the Prime Minister's speech at the CBI Conference in November 2016 indicated that stakeholder representatives on boards are unlikely to be imposed on a mandatory basis).

Other respondents commit themselves more fully on the options suggested. The Investment Association would support any of the options except for designated non-executive directors (because it sees an inherent conflict between the proposed new duty to represent particular stakeholders and a director's existing duty to promote the success of the company); the CBI "would welcome and encourage businesses to put stakeholder representatives on their boards" but principally advocates flexibility (and includes a number of case studies on companies' approaches). Diversity in director appointments also receives strong support in a number of the published responses as a further means of having a range of views represented around the boardroom table.

Corporate governance in large privately held businesses

As it has previously indicated, the FRC stands ready to develop a ***governance framework*** (distinct from the Code) ***for larger private companies***, given that s172 applies to all boards and that many such companies have a significant impact on stakeholders. Support seems to be emerging for the threshold defining 'large' to be 1,000 employees, in line with the Private Equity Reporting Group threshold. The FRC would apply the new framework as minimum requirements for standard listed and AIM-registered companies too.

A number of respondents urge caution, however, and recommend that the need to deal with a relatively small number of 'offenders' should be balanced against additional regulatory burdens for private companies. Recognising the inherent link between accountability and reporting, the CBI and others are willing to have a requirement for large private companies to make their annual reports (including governance reporting) available on their websites – and note that many already do this. The CBI response also includes a number of case studies on the range of governance arrangements in large private companies.

It remains to be seen to what extent the Government takes on board the views of respondents to the Green Paper but there's no doubt that the FRC remains extremely committed and positive about the need for change. Assuming that the Government gives the green light to the FRC's ideas, it will consult on proposed changes to the Code, so there will be at least one more direct opportunity for companies (and other stakeholders) to influence the outcome of the current debate. PwC's response to the Green Paper is available here.

Specific initiatives associated with the Green Paper

Review of the UK Corporate Governance Code

Just prior to submitting its response to the Green Paper the FRC announced its intention to carry out a 'fundamental review' of the UK Corporate Governance Code this year, with input from its "recently established Stakeholder Advisory Panel of high profile representatives from a wide variety of sectors[1]".

ICSA and Investment Association guidance on stakeholder engagement

The Institute of Chartered Secretaries and Administrators ('ICSA' – recently rebadged "ICSA: The Governance Institute") and the Investment Association are collaborating on a project to develop guidance for companies on stakeholder engagement.

[1] The Stakeholder Advisory Panel includes the Chartered Institute of Internal Auditors, Share Action, CIMA, Barclays, Co-operative UK, TUC, RPMI Railpen, the Institute of Customer Services, Centre for Corporate Governance, London Business School, CIPD, IBE, ACAS, High Pay Centre, Resolution Foundation, City Values Forum, CBI, Joseph Rowntree Foundation and GHO Capital Partners.

Without expressing a preference for any of the options set out in the Green Paper, the initiative will address: how companies can identify non-executive directors with relevant stakeholder experience; what processes can help to gather stakeholder views; the need for appropriate training for directors in this area; and how reporting can be improved (consistent with the FRC's suggestions above). The guidance is due to be published in summer 2017.

FRC Developments in corporate governance and stewardship 2016

With so much focus on the BEIS Green Paper on Corporate Governance Reform it's important to also stay on top of ongoing good practice, says PwC's John Patterson.

The FRC published its annual *Developments in corporate governance and stewardship 2016* report ('*Developments*') in January 2017.

On the corporate side, the report looks at the overall state of compliance with the UK Corporate Governance Code ('the Code') across the FTSE 350 and, as usual, sets out a number of areas where the FRC believes that companies could improve their reporting.

The rate of overall compliance remains high in statistical terms. 62% of FTSE 350 companies (2015: 57%) reported full compliance, with 90% reporting compliance with all but one or two of the Code's 54 provisions. Board (and therefore committee) composition remains the area with the highest rate of non-compliance, though this has fallen from 42 companies in 2015 to 26 in 2016. There was an issue in 2015 with newly listed companies not having put governance arrangements in place to comply with the Code prior to their IPO; companies listing in 2016 appear to have addressed this, helping to improve the statistics.

Of the areas where improvement is needed, the quality of comply-or-explain explanations is still a concern after several years of featuring in *Developments*, and the FRC is also now focused on the extent to which companies follow up in the subsequent annual report on significant votes against AGM resolutions. Interestingly, the FRC appears to be suggesting that companies should continue to report on chairmen who were not independent at the time of their appointment beyond the first year that this is the case; this is above and beyond what the Code states, but could be helpful in some circumstances.

This year's publication covers the first year of reporting against the 2014 version of the Code, including the viability statement provision. The FRC's initial assessment of viability statements is that there was not enough variation in disclosures between companies (or even business sectors): it encourages companies to be more constructive "in line with the spirit of the Code". When it looked at a sample of 89 FTSE 350 viability statements from annual reports published up to 31 October 2016, it perceived that only 15% provided a 'comprehensive statement'; 37% were 'minimal' or 'poor'. Set against this, and in line with our own experience, it found that when it commissioned McKinsey to interview companies about their experience of preparing viability statements, many had found the exercise to have served a useful purpose, even if this was not reflected fully in their public reporting.

In the Developments report the FRC notes the publication in November 2016 by the Investment Association of its Guidance on Viability Statements, which sets a relatively high bar for companies in terms of investor preferences and expectations, compared to the general standard in year one. Some boards and management teams will be aware that the Schroders stewardship team subsequently wrote to the chairmen of the FTSE 100 companies in December 2016 encouraging them to look again at the quality of (and period covered by) their viability statements. With the upcoming review of the Code in 2017, it is clear that there is ongoing focus on the quality of viability statements and that investors and the FRC expect best practice to continue to develop.

On the other elements of the 2014 Code, the FRC encourages better reporting on the process by which the effectiveness of the risk management and internal control systems is reviewed, and the findings of the review; it also urges companies to provide disclosure that corroborates the board's confirmation that it has carried out a robust assessment of the principal risks. Again, this is over and above what the Code provision states, but companies should be aware of this steer.

Alongside the 2017 Code review, the FRC indicates that it plans to update its *Guidance on board effectiveness*, following the publication of *Corporate Culture and the Role of Boards: A report of observations* as the initial output of its 'Culture Coalition' initiative, and to reflect the outcome of its discussion paper on succession planning. There is clearly significant overlap between a number of the issues addressed in the Green Paper on Corporate Governance Reform and the FRC's work on culture, with regard for the whole range of stakeholders being an important strand of setting corporate culture.

On stewardship the report focuses on the exercise undertaken by the FRC in 2016 to review the website reporting of the asset owner, manager and service provider signatories to the Stewardship Code. This was grouped into three 'tiers' in November 2016, with those in tier 3 to be removed from the list of signatories unless their reporting is improved by mid-2017. There are no plans currently to review the Stewardship Code before 2018.

With the 2014 Code still bedding in and the 2016 version (along with the revised Guidance on audit committees) to be reported on in earnest in the next reporting season, there is plenty to occupy preparers and audit committees as the debate on corporate governance reform continues. We would also recommend Group members consider to what extent they can adapt their procedures and reporting to pre-empt future changes to the Code in relation to s172 duties.

The FRC's Draft Plan and Budget for 2017-18

The FRC in December 2016 issued a consultation on its Draft Plan and Budget for 2017-18 with a deadline for comments of 17 February. PwC's Graham Gilmour looks at the FRC's priorities and our views on the document.

The top two proposed priorities in the FRC's plan and budget are:

- In light of concerns about trust in business, updating the Corporate Governance Code and associated guidance, and promoting effective investor stewardship.
- Playing an active role with other regulators in helping address the challenges and opportunities of Brexit, and remaining influential internationally.

Other proposed priorities are:

- enhancing the speed and effectiveness of the FRC's enforcement role
- promoting clear and concise corporate reporting
- promoting justifiable confidence in auditing
- promoting high quality actuarial work
- ensuring that the FRC is effective and efficient, and has a corporate culture that supports its mission and regulatory role.

Key features of our response to the Plan and Budget are set out below:

- The FRC is an important voice in setting the tone for trust in the financial reporting and corporate governance landscape. The FRC has an enforcement remit and it is necessarily going to be accompanied by something of a critical narrative. But given its aspiration to be a collaborative regulator focused on improvement, we believe the FRC could do more to balance the critical narrative with promotion of good examples of what has gone well.
- Between the Companies Act and the Code, the UK has a strong framework for corporate governance, but public trust in "big business" has been undermined by a couple of high profile cases. The FRC observes that there is an 'enforcement gap', by which they mean that non-accountant directors are often not held accountable for corporate failures. This is a complex topic spanning a number of regimes with any changes needing careful design.
- We support the FRC playing an active role with other regulators in helping address the challenges and opportunities of Brexit, and remaining influential internationally. Equally as important is that the FRC will need to manage the challenge of maintaining a global approach and international influence against a backdrop of a deregulatory agenda set by the new US administration.
- Levy costs have risen significantly for some firms that audit public interest entities and for some preparers. We believe transparency would be aided by the inclusion in the plan and budget of actual spend for the current period (or at least latest forecast) and more information on how proposed levy increases will impact firms or how they are to be allocated.

The FRC is an important regulator and this is a key opportunity to provide stakeholder input to its activities. We would encourage Group members to submit comments on future years' draft plans and budgets.

Direct and indirect tax

New 'off-payroll' rules for workers in the public sector: Impacts on private sector companies

It would be easy for private sector bodies to think that legislation taking effect from 6 April 2017 regarding workers in the public sector has no impact upon them. However, the new rules can apply to any private sector company supplying workers to the public sector through an intermediary. PwC's Matt Crawford takes a look.

Affected companies are likely to include employment agencies, construction businesses, utility companies and even financial services providers.

Current rules

Currently where an individual is engaged to perform services for an end-user through a UK limited company, in most cases the responsibility to decide if PAYE and NIC needs to be applied sits with the intermediary under the 'intermediaries legislation' (often known as 'IR35'). Many businesses insist on engaging all off-payroll workers through an intermediary as in this way any tax risks associated with the employment status of the individual (i.e. PAYE and NICs) will sit with the intermediary company.

New rules

From 6 April 2017, any company which pays a worker's intermediary company (sometimes known as a Personal Service Company, or PSC) to perform work for a public sector body will have the responsibility of deciding if an individual should be deemed an 'employee' for tax & NIC purposes and making the appropriate deductions and payments of PAYE and NIC when appropriate.

This measure applies to payments on or after 6 April 2017 and so will affect contracts entered into before 6 April 2017 and operating after that date. Companies who are supplying workers to public authorities need to consider existing contracts and prepare for the change.

The definition of a public sector body caught by these rules is widely drawn and includes all bodies which are subject to the Freedom of Information Acts.

Examples

Examples we have seen in practice where private sector companies can be affected by these arrangements have included:

- construction businesses who as part of building or maintenance contracts for public sector bodies supply various workers through intermediaries
- employment agencies who provide workers to schools, hospitals and councils

- financial services firms including banks and building societies who provide consultants to public sector bodies alongside their core product offering.

With 'off payroll' working becoming more commonplace in the UK, we recommend that Group members review their policies and procedures especially where they may provide workers to public sector bodies. Companies with no public sector links should also be mindful of the possibility that additional rules could be introduced in the future which mirror the new public sector rules. Companies should also remind themselves of other recent changes in this area (such as the offshore employment intermediaries rules) and be alert to the fact that the manner in which workers are employed is an increasing area of focus for both legislators and HMRC.

Assurance

IAASB to reset expectations on how to audit estimates

The International Auditing and Assurance Standards Board (IAASB) is poised to release an important Exposure Draft revising its standard on auditing accounting estimates. PwC's Diana Hillier looks at what's being proposed.

At its March 2017 meeting, the IAASB is set to approve an Exposure Draft of a revision to ISA 540, *Auditing Accounting Estimates and Related Disclosures*. In its *Developments in Audit – February 2017 Update* (more later in this section), the FRC notes that one of the emerging trends in its 2016-17 cycle of reviews of public interest entities is that they continue to see examples of insufficient auditor scepticism in certain accounting estimates, such as the assessment of potential impairment of goodwill and other intangibles. The International Forum of Independent Audit Regulators also noted in its *Report on the 2016 Survey of Inspection Findings* that accounting estimates was the audit area with the most frequent findings – with 32% of the audits inspected having at least one finding in that area.

In addition, banking regulators and others have been urging the IAASB to review its standard on accounting estimates in advance of the new expected credit loss model coming into effect.

The revision is designed to:

- modernise the ISA and update it for the new accounting standards
- enhance the auditor's risk assessment for accounting estimates, by focussing on complexity, the need for the use of judgement, and estimation uncertainty
- require a more granular work effort that is explicitly linked to the enhanced risk assessment and the factors noted above.

The proposals direct auditors to probe deeply into, for example, the methods used to prepare the accounting estimate; any models used; the relevance, reliability and integrity of data and assumptions used; how estimation uncertainty has been addressed and whether the related disclosures are reasonable. There is also a renewed emphasis on auditors being alert to indicators of possible management bias in making their accounting estimates.

There is no doubt that the revised standard is intended to drive a robust audit work effort that will provide independent challenge to accounting estimates in company's accounts.

It is expected that the FRC will go through its due process to adopt the international ISA when it is finally released.

This Exposure Draft will be of interest to the 100 Group as it reflects emerging consensus on how to bring greater rigour to the audit of accounting estimates, which may lead to heightened expectations of what companies need to do and document to support their judgements in this area.

Audit Quality Thematic Review into Data Analytics

Earlier this year the FRC published a thematic review looking at the use of data analytics in the audit of financial statements. PwC's Diana Hillier looks at the purpose and results of the review in more detail.

The objective of this review was to increase the FRC's understanding of what stage audit firms had reached in the development of data analytic tools and the frequency with which these tools were being used by engagement teams. This is still an emerging area with the potential to improve audit quality. The FRC wanted to focus on firms' use of such tools to begin to share best practice, as well as develop their inspection staff's knowledge and skills in this area and inform the development of auditing standards.

The review is based on information provided to the FRC in March 2016 by each of the six largest audit firms, findings from client file inspections undertaken by the AQR during 2016 (primarily using data from audits with year ends in the period September 2015 to July 2016), a review of available methodology and guidance and discussions with relevant people in firms' data analytics, methodology and quality teams.

The review found that whilst UK audit firms are at the forefront of developing and using data analytics techniques, their use isn't yet as prevalent as the market might expect. The FRC raised concerns that the pace of development and usage may be overemphasised to meet audit committee expectations, to achieve efficiencies and win competitive tenders. It also commented that a more structured approach to their deployment could accelerate their effective use, and UK audit firms can do more to support their roll-out.

The thematic review gives examples of good practice identified during the course of FRC audit inspections, including:

- enabling audit staff to build experience and confidence in using a specific audit data analytics tool through a structured roll-out programme
- using data analytics for the first time at an interim audit date to improve the prospect of obtaining robust audit evidence at the financial year end, particularly in a first year audit
- improving the effectiveness and efficiency of the extraction of entity data into audit data analytics tools by using dedicated specialist staff and/or dedicated software
- using data analytic techniques to improve oversight and consistency of multiple auditors contributing to group audit where organisations have global accounting systems

The International Auditing and Assurance Standards Board (IAASB) has also just concluded a consultation on *Exploring the Growing Use of Technology in the Audit, with a Focus on Data Analytics* and has released a short video outlining its next steps.

Expanded use of technology, including data analytic tools, has the potential to transform the audit process and improve audit quality over the coming years. Audit committees of 100 Group companies may find the FRC's report valuable in framing questions to discuss with their auditors about their use of such tools.

FRC calls for improvement to quality control practices

The Financial Reporting Council (FRC) is calling on audit firms to improve quality control procedures following its latest thematic review. PwC's Diana Hillier takes a closer look at what the review found.

In its inspections, the FRC has found that one-third of the audits sampled required more than just limited improvements. The FRC conducted this thematic review because, in their view, these results suggest that the quality control procedures adopted by the audit firms are not always effective.

The FRC reviewed six of the largest audit firms, selecting 26 audits from FTSE 100, 250 and other listed companies to look at key aspects of the audit quality control systems used by firms to support their audit teams in delivering quality audits. The review focussed on three aspects of the firms' quality control systems: leadership responsibilities for quality within the firm, human resources, and engagement performance (e.g., technical review of financial statements).

The review identified a range of different practices used by audit firms. The report highlights both areas of good practice as well as areas where improvements can be made. The FRC is now calling on audit firms to improve quality control procedures by building on examples of good practice identified in its *Audit Quality Thematic Review*, including:

- half of the firms have a dedicated board or committee that oversees all matters relating to audit quality, bringing all the elements together and ensuring audit quality has specific prominence and focus in the firm's leadership agenda
- two firms have set out their audit quality procedures in a 'three lines of defence' model. This model visualises how quality control at 3 levels - individual teams, the firm's policies, procedures and resources, and firm level monitoring and assessment for continuous improvement - work together to achieve audit quality and minimise the risk of inconsistency
- initiatives to achieve consistent audit quality, identify areas for improvements and monitor the effectiveness of training in specific areas requiring improvement
- audits with a higher level of partner and director involvement had a greater likelihood of achieving a high quality outcome prior to issue of the audit report.

The FRC also identified procedures by some audit firms that should be a focus for audit quality improvements, including:

- the appropriate involvement of specialists in the audit with sufficient reporting of their work where this was important to achieve audit quality
- that firms should consider whether there are any insights arising from their root cause analysis where their quality control procedures could be enhanced to further improve audit quality.

Audit committees of 100 Group companies will find the report useful in their conversations with their auditors about audit quality. In particular, the shaded areas in the report explain why different audit quality processes are important, summarise the findings of the review for those processes and identify good practices observed.

FRC Developments in audit – February update

The FRC has issued an update to its Developments in Audit 2015/16. PwC's Diana Hillier looks at what's included.

6 months after becoming the UK's Competent Authority for Audit, the Financial Reporting Council (FRC) has released an update to its *Developments in Audit*, published in Summer last year. In it, the FRC summarises key developments against its 2016/17 plan.

The FRC found that while progress has been made, audit quality is not yet consistently and sufficiently high. The FRC believes that audit firms need to focus on the pace of improvement in audit quality and consistency. Given that strong leadership and the right culture are necessary to a faster pace of improvement in, and greater consistency of, audit quality, a key initiative that the FRC plans in 2017 is to review the governance and culture of the eight firms adopting the Audit Firm Governance Code.

Other key findings of the update include:

- Whilst progress has been made on implementing the new standards for auditor independence, concerns have been raised that in dealing with perceived conflicts of interest, not all audit firms are demonstrably serving investors' interests.
- Audit committee chairmen surveyed by the FRC remain overwhelmingly positive about tendering and audit quality. Of those entities responding to the survey that had carried out an audit tender, 70% changed auditors and of those 18% think there has been a significant change for the better in audit approach and quality. To promote effective audit tenders, the FRC has issued updated notes on good audit tender practice.
- The FRC will increase the transparency of its audit quality reviews on individual audit engagements by publishing periodic lists of those entities whose audits it has reviewed. Accordingly, the FRC expects increased reporting by audit committees of its findings and increased investor scrutiny of audit quality.
- An emerging theme from its ongoing 2016/17 audit quality monitoring cycle is insufficient auditor scepticism in identified areas of significant risk such as the assessment of potential impairments and judgements concerning material accounting treatments.
- As highlighted in the FRC thematic reviews, audit firms can accelerate audit quality improvements through root cause analysis and structured support of the introduction of data analytic tools.
- Justifiable confidence in audit is underpinned by sound and effective enforcement. Since July 2016, the FRC has concluded four audit-related cases resulting in sanctions of £6,525,000; begun its first investigation under the new Audit Enforcement Procedure into the audit of Sports Direct International; and following high-profile public announcements, launched enquiries into the audits of Rolls Royce and British Telecom.

The findings in the FRC's update report will be of interest to the 100 Group. Areas of particular relevance may include actions recommended for audit committees, investors and audit firms, as well as the feedback on the FRC's audit committee chairs survey.

Investor engagement

Inside the mind of the investor…What's next?

PwC asked investment professionals about their views on a range of business and strategic issues, with a focus on how globalisation and technology are impacting business. PwC's Hilary Eastman looks at the survey results and what companies could do to improve corporate communications around these topics.

In February, we published our latest investor survey, in which we compared the views of 554 investment professionals with those of the 1,379 CEOs who took part in our 20th CEO survey. We asked the two groups about their opinions on growth prospects, the threats that companies face today, and the challenges and opportunities presented by technological innovation. We also sought their views on the factors that influence the trust placed in business and on the effect and future of globalisation. Their responses unsurprisingly showed a variety of perspectives.

Growth

Despite the considerable political uncertainty across the world, investors' optimism on the global economic growth outlook has more than doubled over the past year and has fed through into expectations for company-specific growth prospects. Investment professionals see the USA as most important for the growth prospects of the companies they invest in or follow over the next 12 months. China comes second, with Germany and the UK tied in third place. The top four countries match those identified by CEOs.

Many investment professionals think globalisation has brought benefits, for example, making it easier to move capital, people, goods and information, as well as enabling universal connectivity and creating a skilled labour force. And while they don't expect the globalisation process to stop or be reversed, they do see some negative effects of globalisation, such as the gap between the rich and poor. The growing disillusionment of the public has resulted in increased geopolitical uncertainty, which investment professionals see as the top threat to company growth prospects. The investors and analysts we surveyed are also becoming increasingly concerned about cyber security and they expect companies to be proactive in addressing cyber risks.

Investment professionals and CEOs both highlight the importance of innovation in allowing companies to capitalise on opportunities, particularly in a dynamic business environment. In our interviews, many investors and analysts highlighted the importance of companies being agile and able to respond to changing consumer requirements and technology.

Technology

Investment professionals think that technology has the potential to change many aspects of what we do and how we do it, including the introduction of autonomous vehicles, new sources of renewable energy, advances in genetic research and FinTech developments. 85% of investors and analysts think companies' headcounts will decrease as a result of automation and the adoption of other technologies. However, in our interviews, some said they expect this to lead to a shift in jobs, not necessarily widespread unemployment. And as automation and new technology may create new roles, investment professionals think that the skillset employees will need in the future will change and employees will need to be creative, innovative, adaptable and able to solve problems.

Investment professionals also talked to us about the impact of technology on trust and the need for governance. They put cyber security, data privacy breaches, and IT outages and disruptions at the top of their list of concerns about digital issues that could negatively impact stakeholder trust. But trust comes in many forms and one of the challenges facing companies today is that data about them, their competitors and industries is produced from so many sources. This makes it harder for them to build a story over time and harder to ensure that what's being said about them is accurate.

Stakeholder expectation challenge

Investment professionals acknowledged the challenge companies face in managing the expectations of different stakeholders, including shareholders, governments and employees. Indeed, 85% of CEOs agree it is important that companies are run in a way that manages the expectations of a wide group of stakeholders (consistent with last year's CEO survey, in which a large majority of CEOs thought they were expected to address wider stakeholder needs). But during our interviews we also sensed evidence of an expectation gap: some investment professionals want companies to focus simply on running the business and focusing on the long-term success of their core business, even when CEOs feel pressured to follow a stakeholder-inclusive approach.

Investment professionals and CEOs – but particularly CEOs – think it is now more important for a company to have a strong corporate purpose that is reflected in its values, culture and behaviours. The greater emphasis placed on this by CEOs is striking – perhaps CEOs need to explain their thinking more clearly so that investment professionals' views become more closely aligned.

This year's research has shown yet again that companies face challenges in explaining clearly how they are capitalising on opportunities, harnessing technology and addressing the many threats they face in today's world. The research identifies a number of areas in which Group members could improve the quality of engagement – and perhaps understanding – between companies and the investment community.

TCFD Phase II Report

The Task Force on Climate-Related Financial Disclosures (TCFD) released its Phase II Report which contains its disclosure recommendations to address concerns that financial implications of climate change are not adequately disclosed. PwC's Hilary Eastman looks at the recommendations provided in the report and how there is increasing investor pressure for such disclosures.

The Task Force on Climate-Related Financial Disclosures (TCFD) was set up by Mark Carney, as chair of the Financial Stability Board (FSB), in December 2015. It is chaired by Michael Bloomberg and consists of 31 industry leaders including PwC Partner Jon Williams. The TCFD's purpose is to develop consistent disclosures for companies to provide information about their climate-related financial risk to investors, lenders, insurers and other stakeholders. Without such disclosures, there were concerns that the financial implications and associated risks of climate change (including transition risks) were not being considered, potentially resulting in ill-informed asset allocation and pricing decisions and, consequently, financial instability.

In December 2016, the TCFD released its Phase II Report which is made up of core recommendations, implementation guidance and a technical annex on scenario analysis. The scope of this Report covers all companies with public equity or debt, irrespective of industry. Financial sectors including asset managers and asset owners, such as pension plans and insurance companies, are also included, and will need to consider companies in their portfolios.

Now that the latest consultation period has closed, the Report will be signed off by the FSB in March 2017 and presented for adoption by the G20 in June/July 2017. Since the TCFD operates under the remit of the FSB, a G20 body, it is highly likely that companies operating in G20 countries will be asked to adopt the recommendations, although approaches may vary from binding regulation to recommended guidance. However, adoption will also be influenced by investor pressure, credit rating and equity valuation concerns, and stock exchange listing requirements.

From discussions with investment professionals, as well as publications by investment houses such as BlackRock, we have seen that climate risks are no longer only talked about by those in the responsible investment or sustainability fields, but are also concerning more mainstream investors. They have started to recognise the potential financial impact of weather disruptions, increased carbon regulation to meet the Paris Agreement and other climate-related events, which could mean reduced revenues, higher insurance premiums and other operating costs and asset impairments. Bloomberg terminals now also have an ESG (Environmental, Social and Governance) platform which includes a Carbon Risk Valuation Tool, further demonstrating the growing demand for such metrics.

And this is where the TCFD recommendations differ from existing sustainability and climate reporting frameworks. Here the focus is more financial, as the TCFD does not just look at physical risks but also transition risks:

- Policy and legal - changes in regulation such as carbon pricing schemes which could influence demand.
- Technology - emerging technologies supporting a low carbon environment which disrupt current practices and existing business models.
- Market - changes in supply and demand as economies react to climate change.
- Reputation - potential damage to brand value and loss of customer base with shifts in public sentiment on climate change.

As investors' understanding of these factors continues to increase, their demand for more consistent information on climate risks will grow. The use of scenario analysis in assessing potential impacts, as recommended by the TCFD, will help narrow the gap between investor expectations and company disclosures, enabling more well-informed financial decisions.

The core recommendations follow current practice for reporting on risks used by corporate reporters, as required by the Companies Act 2006 and the UK Corporate Governance Code, as well as guidance by the regulators. These are based on the broad themes of governance, strategy, risk management and metrics and targets.

Further information on the TCFD's Report and activities can be found here. PwC's Sustainability and Climate Change team has prepared a summary for business leaders including key considerations for implementing these disclosures.

Group members should start assessing whether they are in a position to meet investor and stakeholder demands for climate-related financial information, as investors' expectations for such disclosures will only increase. Although regulatory implementation is yet to be decided, it is likely that investors will use the TCFD's Report to demand these disclosures and so companies will need to apply a high level of rigour and governance in developing them.

Investor Forum publishes its Review and Collective Engagement Report

Having looked at their Collective Engagement Framework published in October 2016 in the last briefing, PwC's Hilary Eastman gives an overview of what the Investor Forum has focused on in its 2015-2016 round of engagement between companies and shareholders. She also looks at what the Investor Forum is expecting from companies to strengthen their stewardship and engagement with investors.

The Investor Forum published its first Review and Collective Engagement report in January 2017, covering its 2015-2016 collective engagement between companies and members of the Forum. The Investor Forum, formed as a result of the Kay Review in 2014, was set up with the objective of making the case for long-term investment approaches and to create an effective model for collective engagement between UK listed companies and institutional investors.

This was the first time the Forum's engagement activities were disclosed publicly, but engagements remain confidential while in progress unless there are exceptional circumstances. Forum members identified 14 UK companies as candidates for collective engagement during 2015 and 2016. Of these, 8 resulted in comprehensive collective engagement, whilst for another 3 investor feedback was provided to the company instead of full collective engagement. The report, which outlines the background, objectives and outcome of each engagement, can be found on the Investor Forum's website.

Some engagements have been on specific issues, but the majority of the Forum's work has been in situations where investors were seeking to recover value after a series of what they see as disappointing developments. Typically, these would relate to one or more of these areas:

- Strategy and capital allocation
- Leadership and succession, including board composition
- Operational performance and management information
- Reporting and communication

In particular, Forum members raised concerns over the execution of transactions and capital-raising exercises, such as the quality of the scrutiny applied by non-executive directors, the representation of shareholder views in the process, skewed incentives which reward completion, and the scale of fees paid. The Forum will be investigating these areas further to identify how to enhance best practice.

Furthermore, investor concerns have ranged not only across traditional financial issues but also broader Environmental Social and Governance (ESG) matters. What has emerged from these engagements is that ongoing open dialogue between companies and stakeholders (not only shareholders) is needed to develop high quality and transparent decision-making on key strategic issues. The Forum's aim is to enable earlier escalation of issues and a more proactive approach to protect and enhance company value.

What next?

From discussions with FTSE100 Chairmen, the Investor Forum identified an opportunity to further refine investor relations practices. The Forum's proposed solution is the 'Stewardship & Strategy Forum', with the objective of increasing confidence that companies are being managed in the long-term interests of shareholders, and to create a stronger understanding between boards and investors. The meeting would bring together key board members, executives, investment decision makers and governance practitioners. They would provide shareholders with the opportunity to evaluate the contribution of the board and the executive in shaping and executing strategy.

The Forum wrote to all FTSE 350 Chairmen to introduce the concept in early 2016. While many support the format and concept, there has been some resistance with some companies viewing it in conflict with existing corporate governance events, and that holding such an event could indicate a level of concern. On the contrary, investors view this as a positive engagement and companies who undertake such meetings would be seen as examples of best practice.

Government is also increasing pressure on boards to pay closer attention to their responsibilities under Section 172 of the Companies Act 2006 to promote the success of the company for its shareholders in the long term and consider wider stakeholders. This type of event would be an ideal platform for company directors to demonstrate how they have met their duties.

The Investor Forum recommends that companies with a premium listing would host a Stewardship & Strategy Forum style event on at least a 3 yearly basis. It can also be used as a platform to communicate and proactively engage on major governance- or strategy-related changes. The Investor Forum also believes that the FRC should consider incorporating this requirement into the UK Corporate Governance Code. While companies can organise such events independently, the Investor Forum would be willing to provide agenda support.

In addition, as part of its Stewardship 360 programme, in 2017 the Investor Forum is intending to hold a small number of key events, small group discussions on topical issues, and write a series of short thought pieces resulting from these discussions. In general, the Forum is not planning to propose new policies but to promote best practice, advocate approaches which facilitate investors' rights, and highlight where existing laws and codes may impede stewardship activities. The Investor Forum intends to work with other investor organisations, particularly the Investment Association, to ensure investor concerns and needs are addressed.

Group members should think about what could be a cause of concern for your shareholders - how would you explain the situation? Would you be prepared for a request for engagement? Also consider planning for a Stewardship & Strategy Forum event, demonstrating initiative that the company values communicating openly with its shareholders and is willing to address their concerns.

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