Welcome to Policy Pulse

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This publication is designed to provide you with an overview of the most important regulatory and public policy developments facing you and your business today, in the areas of reporting, auditing and governance.
The UK is currently experiencing a wide range of regulatory changes and the way we do business is evolving apace. Policy Pulse is here to provide you with the insight and questions that will help you navigate your way through these developments and capitalise on the opportunities they present.

This edition includes content from EY’s leading experts on the topics of investor relations, corporate culture, the role of the audit committee in a post-EU audit reform world, audit innovation and succession planning. We have also included examples of the most significant regulatory updates and consultations to make the news in recent months.

As you will see, there is constant change in the regulatory and policy space, much of which will have a wide ranging impact on UK companies. To discuss any of these articles in more detail, please contact EY’s Regulatory and Public Policy team.

Eamonn McGrath
UK Head of Regulatory and Public Policy
Dialogue with investors
What investors really think

Investor stewardship is re-emerging as a regulatory hot topic. For example, the Financial Reporting Council (FRC) plans to assess the effectiveness of the UK Stewardship Code in 2016. As an audit firm we have a vested interest in this. This is because investors underpin the UK’s corporate governance regime, and of course they are the ultimate client of any audit firm.
Investor Dialogue - exploring the best questions with leading investors

Twice a year we bring investors together and facilitate collaborative and constructive conversations, between their community and ours. These Dialogue with Investors events have run since 2013 and provide valuable insights on what investors really think about the latest hot topics in corporate governance, reporting and auditing.

From a public interest perspective it is essential that we understand their needs and objectives, and ensure our services deliver for them. At the last event in November 2015 the audience represented over £2.5tn of global investment power. So what they have to say really counts, and we are proud to play a part in bringing our respective professions and interests closer together.

In November 2015 we polled a number of these investors to see what they had to say about EU audit reform, corporate culture and audit innovation.

EU audit reform – a further boost to investor confidence

There are now less than four months to go until the UK’s implementation of the EU’s audit market reforms. These will have a wide ranging impact on companies, not least because of the introduction of mandatory audit firm rotation (MFR). It was therefore encouraging to hear that 80% of investors think the increased number of tenders will boost their confidence in auditing.

Good corporate culture – seeing is believing

Investors understand the importance of culture as a driver of company performance. This is why they are keen to gain additional insight into the culture of their investee companies. Of course, no investor wants shares in the next company to be hit by a corporate scandal, but measuring the strength of a culture and spotting its weaknesses before it is too late is easier said than done. It all depends on which questions are asked, when, and of whom.

Investors also need to use consistent measures, so they can compare one company’s culture with another’s. This is in addition to help and support from external auditors who can get under the skin of a business.

In our poll only 32% of investors thought it was possible for companies to assess and report on their corporate culture, while 61% thought it only possible ‘to an extent’. 81% believe companies do not provide information that allows investors to assess corporate culture, and 85% believe they as investors have a role to play in relation to the culture of the companies they invest in.

This shows willingness on their part to do more in this space, along with a general consensus that a more robust framework is needed to gauge corporate culture effectively.

Innovating audit with big data

53% of investors said they do not think the audit profession has innovated very much over the past two decades, but 82% believe the next decade will see a lot of innovation. One of the drivers of this innovation could be the growth of ‘big data’. Research by Oxford University predicts that the audit and accountancy profession is the second most likely profession to be impacted by this phenomenon over the next ten years².

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1 Draft plan & budget and levy proposals 2016/17, FRC, December 2015
2 The future of employment: How susceptible are jobs to computerisation? Oxford University, September 2013
Contrary to public perceptions, we have seen over the last five years the greatest level of audit innovation in a generation. This can be attributed in part to the effects of EU audit legislation, which came into force on 16 June 2014. This has increased the level of competition in our markets, with 46 FTSE 350 companies tendering their external audit in 2015, as opposed to 27 in 2014. FTSE 350 companies’ disclosures on external auditor appointments increased from two per cent in 2008 to over 50 per cent this year.¹
Digitisation and the Blockchain phenomena

Another key driver of innovation is the digital era or, as some call it, the ‘4th Industrial Revolution’. Social, political and corporate life is changing by the proliferation of data, combined with the ‘Internet of Things’, robotics, and artificial intelligence.

Such is the pace of this change that according to various studies most of the world’s data has only recently been created. ‘Every day we create 2.5 quintillion bytes of data - so much that 90% of data in the world today has been created in the last two years.’

Personal data devices are becoming ubiquitous and set to grow exponentially. This is allowing us to interact and consume services in new ways. Gartner predicts that by 2020, around 85% of customer transactions will be done without a human being involved in the sale process. So called ‘Blockchain’ technology appears to be in a position to completely transform the transparency and security of transaction processing.

So the risks potentially shift from numbers being recorded accurately by finance teams, to a world where the ‘black box’ records and processes the transactions. But who will understand the black box?

Questions worth asking

- What are the board’s views on audit innovation?
- How would the board make use of assurance on a broader range of risks and issues?
- To what extent is the audit committee familiar with data analytics and the implications for future audits?

Knock-on effects - the evolution of innovation

Understandably, as a result of all these changes audit clients are asking: ‘What’s the audit going to do for me?’ Likewise, their investors want to know how tomorrow’s audits are going to provide assurance on more than just the numbers.

In our opinion, innovation is focused around three main areas.

**Firstly**, by casting the net more widely, auditors will be looking more closely at risks beyond finance and reporting. For example, failures in corporate culture have played a role in recent high profile scandals. As a profession we need to go further in performing more extensive and intrusive fraud risk procedures. Also, given the increasing reliance on the ‘black box’, IT risks such as cyber security and major IT programmes will become more materially significant to the scope of the audit.

**Secondly**, through the continuous exploitation of new technology and big data, auditors are already making good use of client technology and data, supplementing it with external data to build a picture of issues and risks. This will continue to evolve quickly, fundamentally re-engineering traditional assurance approaches and providing insights into risk and performance beyond those shown in the books. For example, in some cases auditors are already downloading and analysing full populations of data to spot issues with controls or processes.

**Finally**, by ‘taking the robot out of the human’, we are starting to automate the more routine manual audit activities. This saves time for auditor and client alike, freeing up more time to focus on the really big issues and risks such as accounting judgements.

In conclusion, the ‘4th Industrial Revolution’ will not only reshape society, politics and business. It will also provide an opportunity for the audit profession to set new standards and give greater trust and confidence in a changing world. The innovations to come will be widespread, from analysing data and spotting issues before they become life threatening, to widening the scope of assurance so it remains just as relevant tomorrow as it is today.
Corporate culture
Coming of age with new management techniques

There is evidence to show that dysfunctional cultures are at the root of many corporate scandals. In response the FRC has launched a ‘Culture Coalition’, a market-led initiative looking at the topic of culture.

The objective of the coalition is to gather insight into corporate culture and promote a better understanding of how boards can assess, shape and embed the right culture for their businesses. The initiative comprises four work streams, including one focusing on the relationships between culture and a company’s business model, stakeholders, wider community and environment.
Questions worth asking

- How does the board define its culture?
- How does the board define the culture of the people in its business?
- To what extent do these and other cultures in the company feature in its reporting?

Reporting the intangible

When companies report on their performance in annual reports it seems that many pay little regard to one of the key drivers of that performance: corporate culture.

This may be a 19th Century throwback when legislation first required companies to publish information on the value of their business. This was, for the most part, tangible information on financial performance. Nowadays, the proportion of stock market value attributable to tangible assets has significantly reduced, with a corresponding lack of measures and standards to value and report on intangible assets, e.g. corporate culture.

If you can't measure it, you can't manage it

Many companies find the task of understanding, measuring and assessing culture difficult. This is because the tools and techniques they are familiar with have been honed for measuring and reporting quantitative financial data. Culture requires something altogether different. Companies may find a qualitative analysis of a much broader range of measures unconventional and trickier to manage. However, it is not as difficult as many first suspect.

When assessing a culture it is important to acknowledge that there is rarely a single culture within a company. Leaders can influence culture by developing a clear purpose and set of values that they promote through their actions on a daily basis. But cultures are created locally as people’s beliefs, values and behaviours influence their decision making. An understanding of these subcultures, influenced by local leadership, is necessary to comprehend the overall health of a company.

Traditionally, many companies only focused on systems, procedures and rules. Today, we are finding that whilst rules influence behaviour, it is also important to evaluate the interrelationships and power structures that shape the working environment. These are the political and social architectures that affect beliefs and decision making in the workplace, alongside performance and operational architectures.

New tools and methodologies that identify what people believe in and value, and what influences their behaviours and how they make decisions, are becoming increasingly important. These are being applied alongside data analytics and ‘sentiment analysis’, to look for evidence of stress or pressure on local teams that might lead to decisions that are not in line with the company’s purpose and values.

When coupled with the traditional methods (systems, procedures and rules) these new approaches provide a more robust view of corporate performance. The combined effect helps to highlight areas of risk and what it is that leads some teams to work in line with leadership’s stated purpose and values (a sustainable performance) and causes others to deviate.

How we are working with clients to assess culture

EY’s Corporate Integrity and Compliance Team helps companies to improve the way they assess culture. We take cultural analysis beyond the conventional boundaries of performance and operational review, and analyse the political and social factors affecting beliefs, behaviour and decision making.

Our proprietary tools examine culture and subcultures at a micro-level. They enable clients to pinpoint key areas of concern, whilst identifying improvements and streamlining change across teams or entire enterprises. It is a proven approach based on leading academic thinking, including a benchmark of over 140,000 individuals in companies and other organisations across multiple sectors.

*Culture and the role of the internal audit - looking below the surface, Chartered Institute of Internal Auditors, June 2014*
Succession planning
Rising to the top of the FRC’s agenda

In October 2015 the FRC published a long awaited discussion paper on the subject of succession planning. We are encouraged by this, from a policy perspective, for two reasons.
Firstly, effective succession planning by nomination committees helps to contribute to the long-term success of companies. Secondly, the FRC is now focusing its attention on the nomination committee in terms of examining how it can play its role more effectively and develop good practice.

**In responding to the FRC’s paper we outlined the following:**

**Link with strategy – succession planning at its best**

Succession planning should be linked to a company’s strategy. It is a means primarily for sustaining the optimal composition of a board and its committees for the realisation of that strategy, and a revision or replacement of that strategy if/when required. It is also a tool boards can deploy to help develop the right culture for their business. Appointing people whose values, behaviours and sense of purpose are aligned with, and mutually supportive of, the desired culture.

The nomination committee should develop specific search and selection criteria in its succession plan. This should match the skills, experience and expertise required by the board to deliver the company’s strategy.

The committee should then compare those criteria against the medium and long-term strategy and adjust accordingly, if the requirements expected of the future candidate for the board vary between the medium and long-term. The plan should then be reviewed and updated periodically to anticipate potential changes in the company’s circumstances (e.g., markets or financing) where a board director might need to be replaced by someone altogether different.

Finally, the committee should provide briefings and updates to the search agency to ensure they are attuned to the company’s circumstances, and any changes (actual and potential) to the plan.

**Link with culture – sustaining the right culture**

Methods for linking a succession plan to a company’s culture include the development of detailed job specifications. These should include the company’s expectations in terms of the values, behaviours and attitudes of its board members and other employees.

The specifications should then be incorporated into psychometric testing and 360 assessments of potential candidates, to gauge the degree of alignment or misalignment between the candidate’s values, etc., and those of the company. A tool often used for this purpose is the so called ‘9 box grid’ system. A copy can be found on the Chartered Institute of Personnel and Development website.

**Reporting – telling it like it is**

The company should also publish the succession plan to show how people are recruited, rewarded, retained and promoted. This will help to communicate the culture of the company and accordingly attract candidates who share the same values.

The optimum report starts with a clear explanation of the skills, experience and expertise of the incumbent board members. This should cover a range of variables including diversity of thought, level of challenge and background, rather than just a list of previous positions held by each member.

The report should map these ‘credentials’ against the medium and long term strategy. This identifies current and potential gaps in terms of what is required of the board to deliver the strategy. This could also include the business model (e.g., how people are engaged to develop tangible value).
So the succession plan is seen as the means to close any gaps, and it should be reported as such.

If there are no gaps to fill at the present time the nomination committee should report on its approach towards succession planning generally. To explain how it keeps track of when directors are due to rotate off the board, thereby allowing enough time for due processes to be undertaken to ensure new directors of the right calibre are appointed.

It remains to be seen how the FRC will implement the findings from this consultation. We advocate proportionate and practical measures that will help to raise the bar, rather than a more rules-based compliance regime.

Our research and findings

Succession planning is a subject we are familiar with at EY. Our Corporate Governance team stated in their review of 2013 FTSE 350 annual reports and accounts, that the nomination committee remains the ‘poorer cousin’, at least from a reporting perspective.

In April 2015 the same team examined this issue, amongst others, in more depth with a series of roundtables and interviews with institutional investors, senior executives and non-executive directors. This culminated in a report on board effectiveness, published together with the Investment Association.9

To further our work in this area colleagues in the Corporate Governance team are conducting a joint project with the Institute of Chartered Secretaries & Administrators (ICSA) over the course of the next two months. Via roundtables with nomination committee chairs and members, as well as company secretaries, the team will examine how the nomination committee performs its role.

The aim is to progress the debate on succession and explore new ways for the committee to operate. If you are interested in taking part, please email: corporategovernance@uk.ey.com

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7 Board Succession Planning, FRC, October 2015.
8 Out with the old, in with the new, observations from EY’s review of December 2013 annual reports in the FTSE 350, with recommendations for 2014
9 Board effectiveness – continuing the journey, EY and IA, April 2015
Audit committee chairs

Implications of EU audit reform

The EU Audit Directive and Regulation, which apply to financial years beginning on/after 17 June 2016, will have a significant impact on the market for professional services, including the external audit. However, EU audit reform is also about enhancing the requirements that apply to Public Interest Entity (PIE) audit committees.
The EU Commission sees a PIE Audit Committee (AC) as having 'a decisive role to play in contributing to high-quality statutory audit' and states that competent authorities should monitor their performance (although it is currently unclear what this will mean in practice).

Under the EU Audit Directive, non-listed banks and insurers (and, as proposed by the PRA, UK designated investment firms) previously exempted are now required to have an AC (and, in the UK, the PRA consulted on extending the requirement to unlisted PRA designated investment firms).

AC chairs will need to either satisfy themselves that these enhanced requirements formalise their best practice arrangements, or identify what action needs to be taken both to enable them to comply and to evidence compliance. Examples of EU-driven changes that ACs will need to address are shown below.

**AC composition**

**Independence:** A ‘majority’ of AC members (including the chair) will have to be independent of the PIE whereas currently, ‘at least one’ member must be independent.

**Technical competence:** At least one member will have to have competence in accounting and/or auditing (whereas the current UK Corporate Governance Code (the Code) makes a provision for at least one committee member to possess ‘recent and relevant financial experience’).

Committee members as a whole will also have to have ‘competence relevant to the sector’ in which the PIE operates. AC chairs will need to decide how to interpret this provision relative to their PIE, whether the committee’s current mix of competencies measures up, and whether additional expertise is needed (in which case they are likely to face increased competition for candidates).

**AC roles and responsibilities**

**Auditor independence:** The audit committee will be responsible for reviewing and monitoring the independence of the auditors and, under the EU Audit Regulation, it will be required to provide guidance on and approve (on a case-by-case basis) the provision of non-audit services (NAS).

This will include a requirement to monitor the audit firm’s compliance with a cap on fees for permissible NAS (set at 70% of the average group audit fees, calculated on a rolling three year basis). The cap will apply from 2020 to NAS provided by the auditor and its network, to the PIE and its subsidiaries worldwide.

**Audit tender process:** The AC will have ownership of the audit tender and appointment process, including the task of recommending prospective audit firms to the board. ACs will also need to ensure that if a prospective audit firm designed and implemented the PIE’s financial systems, that work must have ceased for a minimum of 12 months before the firm can be appointed as the external auditor.

**Implications for ACs in the UK**

For UK companies with listings on the London Main Market, the EU requirements will be implemented in the Financial Conduct Authority’s (FCA’s) Listing Rules and also incorporated in the Financial Reporting Council’s (FRC’s) Code, Guidance on Audit Committees (the Guidance) and in relation to auditors the Ethical Standard. Banks, insurers and, subject to the consultation outcome, PRA-designated investment firms will be subject to additional PRA rules.
The FRC has also consulted on additional changes that would impact audit committees in the UK. Examples of these ‘proposed changes’ are outlined below.

**Advanced notice and explanations:** This includes a new provision in the Code requiring ‘advance notice of retendering plans in the audit committee’s annual report’. The Guidance says that changes to an intended date of tender should be explained in the same report.

**Restrictions on AC membership:** A new provision in the Ethical Standard restricting the appointment of partners from audit firms. For example, if a partner were to be appointed to an AC, his/her former firm would be prohibited from accepting an appointment as that company’s auditor for a period of two years.

**Further reporting by ACs:** Amendments to the Guidance encourages ACs to undertake additional communications with investors, including disclosures on the ‘nature and extent of the company’s interaction (if any) with the FRC’s Corporate Reporting Review Team’. If the company’s audit has been reviewed by the FRC’s Audit Quality Review Team, the AC should also ‘discuss the findings with their auditors and consider whether any of those findings are significant and, if so, make disclosures about the findings and the actions they and the auditors plan to take’.

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10 It is a PIE if it is incorporated in an EU member state, with equity or debt listed on an EU-based regulated market (e.g., FTSE). This includes funds (e.g., UCITS or AIF). You are caught if your business is in banking or insurance whether listed or not and subject to the laws of an EU member state.
Recent regulatory updates
Developments worth watching

UK Policy
BIS implementation of the Non-Financial Reporting Directive (NFRD) and a call for views on effective reporting.
In February 2016 BIS issued a consultation on its plans to implement the NFRD. It is also seeking views on ways to reduce reporting requirements in the UK. The Directive introduces EU-wide disclosure requirements for companies to report on various non-financial matters e.g., environmental, social, employee, human rights, anti-corruption and bribery, and board diversity. The Directive takes effect from 1 January 2017.

FRC audit quality thematic review
In January 2016 the FRC published its thematic review of audit firms’ policies and procedures for reviewing the quality of their own audits. It considers how these activities are applied in order to make comparisons between firms and encourage good practice, as well as informing audit committees and company stakeholders.

FRC/BIS proposals to implement EU audit legislation in the UK
The FRC and BIS, on the 29 September and 28 October 2015 respectively, issued detailed proposals on how they intend to implement in the UK, EU legislation on reforms to auditing.

FRC promotes clear and concise reporting via the strategic report
This report, published in December 2015, includes advice on how to produce clear and concise annual reports and accounts. It also provides an overview of developments in narrative reporting, including references to the FRC’s earlier publication ‘Guidance on the Strategic Report, 2014’.

FRC’s proposals for UK board succession planning
This paper, published by the FRC in October 2015, seeks views on planning effectively for board succession. It refers to executive and non-executive directors, and what nomination committees need to do to support a suitably talented and diverse ‘pipeline’ of future board directors.

FRC report on developments in corporate governance and stewardship 2015
The overall quality of corporate governance in the UK remains high, according to the FRC’s report ‘Developments in Corporate Governance and Stewardship 2015’ published in January 2016. This report details developments around governance, reporting, audit and investor stewardship.

FRC review of the UK Audit Firm Governance Code (AFGC)
The FRC’s most recent proposals to change the AFGC, published in January 2016, reflect views from an earlier consultation which included requests for various provisions in the code to be clarified and in some cases strengthened, e.g., more detailed disclosures by the independent non-executives.

ICAEW’s Code of Ethics
In November 2015 the ICAEW published draft guidance on its Code of Ethics, in regards to managing conflicts of interest and the accountants’ role vis-à-vis the public interest. This is in response to the MG Rover scandal and the resultant tribunal, which noted that these matters were in need of clarification in the code.

ICAEW seven questions company report writers should ask themselves
The ICAEW published a guide on ways to make annual reports clearer and more relevant. Published in January 2016, the contents of the guide are based on findings from company auditors.

ICAS Code of Ethics
As part of its remit to promote ethics and integrity in business and the profession, the ICAS Ethics Committee has reviewed the ICAS Code of Ethics. This includes a proposal for the addition of a new principle on moral courage, and an overall assessment of the other principles to make sure they remain fit for purpose.
ICSA draft guidance for companies and LLPs – People with Significant Control

From 6 April 2016 private companies and Limited Liability Partnerships (LLPs) must keep a register of individuals or legal entities that have a significant control over them. Companies must continue to keep other information, including a register of shareholders and a register of directors.

EU Policy

European Commission consultation on cybersecurity public-private partnership


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