Policy Pulse contents

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Our 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.
With economic, political and social change comes uncertainty, and uncertainty creates risk and disruption. As business leaders we are not only witnessing these circumstances, we are having to manage and mitigate the consequences.

**Business confidence**

For example, business confidence will fall or rise depending on how the Brexit negotiations progress, and whether the UK will achieve a trade agreement on or before March 2019. Lower confidence generally leads to a lack of investment – long or short term – with implications for the health of the UK economy. Unfortunately, there are early warning signs that the ongoing uncertainty associated with Brexit is beginning to have a negative effect. For example, the Office for National Statistics (ONS) reported a slowdown in business investment, which fell by 1% between the third and fourth quarter of 2016.\(^1\)

This is reflected in a longer term forecast offered by the EY ITEM Club, which estimates that the UK’s growth in GDP is likely to reach 1.8% this year, and fall to only 1.2% in 2018. However, exports are expected to grow by 6.7% this year, and 5.3% in 2018, thanks to a timely revival in our overseas markets. Indeed, world trade and industrial output are growing faster than at any time since 2010.\(^2\)

**Post-Brexit**

In terms of public policy, the Government will have its work cut out dealing with the change-over post-Brexit. For example, according to Thomson Reuters 52,741 laws have been introduced in the UK as a result of EU legislation since 1990.\(^3\) According to the House of Commons Library, 6.8% of primary legislation (Statutes) and 14.1% of secondary legislation (Statutory Instruments) had a role in implementing EU obligations between 1997 and 2009.\(^4\)

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1. ONS, ‘Business investment in the UK, Oct to Dec 2016 revised results’, 31 March 2017: ‘Between Quarter 3 2016 and Quarter 4 2016, business investment, in volume terms, is estimated to have decreased from £44 billion to £43.5 billion.’
2. EY ITEM Club, Spring Forecast 2017, 10 April 2017.
3. According to Thomson Reuters
4. According to the House of Commons Library
Populism and international trade

As economies begin to falter, and certain members of society begin to feel excluded from a country’s economic wealth, nations can become politically insular and we get a rise in so-called populism. The new administration in the US, and the outcome of the general election in the Netherlands with Geert Wilders’ ‘Party for Freedom’ coming second, are recent examples of this development. Campaigning for the French presidential election, and the gains in the early opinion polls made by Marine Le Pen’s ‘National Front Party’, is further evidence of this trend towards populism. We do not yet know the implications of these political machinations on international trade and access to markets, but ‘not knowing’ is a challenge in itself, especially for business and investors.

National security and regulatory intervention

Whilst the Government is managing the distractions presented by Brexit, other pressing issues will prevail. For example, national security and the threat of terrorism and criminality (e.g., cyber, corruption, bribery and money laundering) show no sign of abating. The UK’s terrorist threat level remains at ‘severe’, and the number of companies subjected to cyberattacks is on the rise.

We found that 57% of respondents to our Global Information Security Survey (from a sample of 1,735 CIOs) have had ‘a recent and significant cybersecurity incident’. Indeed, ‘87% of board members and C-level executives said they lack confidence in their organisation’s level of cybersecurity’. Apart from the reputational fallout of a data breach, the General Data Protection Regulations which take effect next year will introduce significant financial penalties if companies fail to report a breach: a fine of 20 million euros or 4% of gross annual turnover, whichever is the greatest.

Public interest

Apart from the need for greater vigilance and controls to counter the threats mentioned above, business leaders also need to be mindful of the ethical dimensions of how their companies operate. Recent public debates about executive remuneration, tax planning and corporate governance in general has led to increased scrutiny of the way businesses operate. This manifests itself in various forms. The UK Government’s recent Green Paper on Corporate Governance Reform is a good example, showing how the ‘public interest’ dimension of business conduct remains on the political agenda.

5. EY’s 19th Global Information Security Survey 2016/17
6. EY’s 19th Global Information Security Survey 2016/17
7. Policy Pulse, January 2017
The growing prominence of audit and assurance

What I have described above leads us to reach one very important conclusion: risk and uncertainty are inevitable consequences of a multitude of interconnected developments, whether they stem from economic shocks or geopolitical changes. These are forces beyond our immediate control, so instead we have to get on with the task of managing and mitigating the associated risks: to make the best decisions we can with the information at hand. Therefore we need to be assured that the information we use (e.g., the annual report and accounts) is true and fair, balanced and understandable.

As auditors we understand the need for assurance, and the reliance placed on our opinions. In this regard our intentions can be best summed up with the views that Gay Huey Evans OBE (Deputy Chairman of the Financial Reporting Council (FRC)) kindly shared with us in this edition of Policy Pulse. Like the FRC, we are also committed to helping ensure that ‘companies produce the trustworthy information necessary for informed investment decisions’. Not surprisingly the emphasis placed on audit quality is greater than it has ever been, and this is driving us to become more innovative with developments like audit data analytics, artificial intelligence and the use of psychologists to help coach and train our auditors.

Keeping your finger on the pulse

With so much changing in policy and regulation it can be difficult keeping a track of things. This is why I think publications like Policy Pulse matter. We all have a vested interest in keeping our finger on the pulse, and any guidance on what’s up and coming has got to be a good thing. So I encourage you to read on. This edition of Policy Pulse includes content from EY’s experts on:

- Long-term value
- The ethics of artificial intelligence
- IFRS 16
- Audit quality
- The implications of the Government’s proposed corporate governance reforms
- Cybersecurity

In addition, as I mentioned above, we are delighted to include comments from Gay Huey Evans OBE, on the FRC’s plans for regulation in 2017/18.

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
Defining more effective measurement and reporting of a company's value
Defining more effective measurement and reporting of a company’s value

We often report the wrong things: measuring what is easy rather than what is right.

Intangibles, now account for around 50% of the market value of many organisations.

Our Long Term Value (LTV) model takes account of the purpose and context of a company: how its activities support its strategic assets, and how those assets deliver measurable value.
The time has come to rethink how we account and report on organisational performance: shifting from an implicit understanding of the value that broader activities of a company bring to stakeholders, to explicit external verifiable evidence of outcomes.

Recent developments, such as integrated reporting and the strategic report, have made significant enhancements to the quality and usefulness of reporting. However, there is still a significant and increasing disconnect between the different stakeholder groups and their information requirements.

We believe that there are four fundamental challenges for reporting. First, accounting profit and shareholder returns are disconnected. Profit is quick to recognise short-term changes in revenues and costs, but does not account for investments made for the long-term. This is putting pressure on organisations to deliver short-term results. While this may be aligned to the interests of some investors, there are many who invest for the long-term. Second, we often report the wrong things: measuring what is easy rather than what is right. This is particularly true of intangibles, which now account for around 50% of the market value of many organisations. Third, the failure of organisations to address growing environmental, social and governance (ESG) pressures adequately is diminishing trust in organisations.
Over the past 18 months we have worked with various stakeholders (leading academics, business leaders and investors) to test our LTV framework/model. It shows how organisations can improve their measurement and reporting, by identifying four broad categories of these tasks which need to evolve:

1. The development of alternative measurement frameworks.
2. A call to report on intangible assets.
3. The evolution of accounting and reporting standards, including the strategic report.
4. The development of integrated reporting.

The stakeholders agreed that for any reporting model to succeed, the reports that arise from its use and application need to pass the following six tests:

1. Be clear about the context of the disclosures.
2. Results must be material to stakeholders.
3. Contents to be core to the purpose, strategy and business model.
4. Be assured and trusted.
5. Provide a more complete view of value.
6. Be simple to understand.

Our LTV model takes account of the purpose and context of a company: how its activities support its strategic assets, and how those assets deliver measurable outcomes for its stakeholders. To drive change in the way companies measure and report on their value, we have to encourage them to report ‘explicitly’ on their measurable outcomes to their stakeholders.

One way of doing this is to engage publically on third-party research papers, proposals and policy consultations. For example, we contributed recently to a policy paper issued by the ‘Big Innovation Centre’s Purposeful Company’. This is a consortium (of FTSE companies, investment houses, business schools, consultancy firms and policy makers) which examined how corporate governance and the capital markets in the UK may be enhanced to support the development of companies that generate long-term value for all of their stakeholders.

A key recommendation, put to the Chancellor of the Exchequer and Secretary of State for the Department for Business, Energy & Industrial Strategy, is that the EY LTV model should be piloted in the UK alongside certain reporting standards, with the ultimate aim of replacing them.

These three challenges have resulted in regulators and legislators demanding that organisations release ever greater levels of detail about their performance, leading to the fourth challenge: over-burdensome regulation and increased demands for information resulting in reduced reporting clarity. If executives are to address these challenges, they will need to account for, and explain, organisational performance far more clearly and coherently.
Questions worth asking

- To what extent is the board and management able to demonstrate how the organisation creates value over the long-term?
- What would be the benefits if they would be able to do so?
- Is it time to rethink how the organisation accounts for and reports on value?
Challenges ahead for FRC
In December 2016 the Financial Reporting Council (FRC) published its draft plan, budget and levy for 2017/18 (the Plan). It outlines a range of regulatory duties and proposed initiatives, with an indication of costs and an explanation of funding.

Challenges ahead for FRC

The FRC mission is to promote high quality corporate governance and reporting to foster investment.

Regulators need to be wary of creating unnecessary costs for business.

We will continue to deliver our statutory and other responsibilities, to work closely with fellow regulators and with Government.
Our mission is to promote high quality corporate governance and reporting to foster investment. To support our mission we have two strategies, both designed to support investor and wider public confidence: to encourage companies to produce the trustworthy information necessary for informed investment decisions; and to encourage trustworthy behaviour by directors and professionals and engagement with them by investors. Across all our activities we operate in the public interest.

‘In consulting on our priorities for 2017/18, we are conscious that there are significant challenges facing society as a whole. Economic and political uncertainties, and the serious public concerns about the behaviour of some businesses, are bad for growth and prosperity. The FRC cannot, of course, address these problems alone, but it can make a contribution through its role in promoting strong corporate governance and encouraging better recognition by business of public perceptions. In a period when businesses are facing a high degree of uncertainty, regulators need to be wary of creating unnecessary costs for business. The strategy for 2016/19 that we published in October 2015 was based on a regulatory approach that supports market participants in improving standards, and using our enforcement powers when necessary. This remains a key plank of our work going forward.

‘We will continue to deliver our statutory and other responsibilities, to work closely with fellow regulators and with Government, and to represent UK interests in the EU and internationally. We will continue to use the important new role we have been given by Government as UK Competent Authority for audit to promote continuous improvement in audit quality, underpinned by effective and timely enforcement. We will refresh our approach to actuarial oversight to take account of the changing risks to the quality of actuarial work.’

Interview with Gay Huey Evans OBE

What follows is an interview with Gay Huey Evans OBE, Deputy Chairman of the FRC. She has kindly shared her views with us on the Plan and what challenges lie ahead for the FRC. To provide some context for this, a brief excerpt from the Plan is included below.
Questions & Answers

1. What steps will the FRC take to help ensure it achieves the right combination of ‘high standards and low burdens’?

When the FRC revises audit related standards and guidance, we carry out impact assessments to evaluate identifiable costs and benefits arising from our proposals, and we also put all of our proposals out for public consultation. In audit, we have also been working collaboratively with a range of stakeholders including audit firms, professional bodies, investors and audit committee chairs to deal with questions arising from the implementation of the EU Audit Regulation and Directive. This has allowed us to minimise the need for additional guidance and instead build a shared understanding of the key issues and how we should approach them.

2. What aspects of corporate reporting cause the greatest concern for the FRC?

The FRC provided its assessment of the quality of corporate reporting in its October 2016 publication ‘Annual Review of Corporate Reporting 2015/16’.

We reported that compliance with the reporting framework is generally good – particularly by larger public companies – and that the introduction of the strategic report has improved the quality of narrative reporting. We did not express significant concerns about any specific aspects of corporate reporting.

We did, however, highlight some areas where there was room for improvement in quality. These include disclosures around significant judgements and estimates and certain aspects of alternative performance measures. We also noted the level of current stakeholder interest in pensions reporting.

3. What is the FRC planning to do about this?

In formulating our work programme for 2017/18, we identified that these areas of reporting are also of particular interest to investors.

To prompt improvement in these areas the FRC’s Corporate Reporting Review (CRR) team will conduct thematic reviews of the relevant reporting requirements in 2017/18. The CRR have pre-informed some 60 preparers that a specific aspect of their forthcoming reports and accounts – one of the three noted above – will be subject to review. This may encourage boards to make any desired improvement in those areas ahead of publication, meaning that better quality information is in the public domain at an earlier point than if we first engaged with companies once they had published their next accounts.

This was the FRC’s experience in respect of the tax thematic review which we conducted last year.
The CRR will report on their thematic reviews identifying the better disclosures they see and which can act as a benchmark, against which other preparers can compare their own reporting.

Our annual assessment also acknowledged that stakeholders continue to be concerned about the length and accessibility of the annual report and accounts. The FRC is committed to promoting clear and concise reporting which both informs the guidance it produces, and shapes its response to international developments in corporate reporting.

What measures does the FRC plan to undertake to ensure that 90% of the audits it inspects amongst the FTSE 350 will only require, by 2019, limited improvements?

The FRC can only deliver upon this target by influencing continuous improvement in audit quality at the audit firms that undertake audits of FTSE 350 companies. This influencing takes a number of forms.

The routine inspection work of the FRC’s Audit Quality Review (AQR) team: Through its inspection work the FRC aims to hold firms to account for the quality of work which they carry out. Each year the FRC publishes individual reports on the major firms, summarising common findings and the overall inspection results. An important element of the report is an outline of the actions that the firms propose to make to address common failings, grounded in the root cause analysis that the firms will have carried out. It is important to note that the FRC team also seeks to identify examples of good practice and to reflect this back to the firms so that they can seek to embed it more broadly. The inspection process itself also provides an opportunity for the FRC inspectors to share insights at a general level gained from inspecting the firms.

The thematic reviews published each year by the FRC: The FRC has been publishing thematic reviews on audit since 2013. In a thematic review we look at the firms’ policies and procedures in respect of a specific area or aspect of the audit or firm-wide procedures. We do this to make comparisons between firms with a view to identifying both good practice and areas of common weakness. The reviews are deliberately focused in scope, and are chosen to review, in more depth, an aspect of audit or firm-wide procedure than is generally possible in one of our audit inspections. The most recent thematic reviews published by the FRC have been on ‘Root Cause Analysis’, ‘Data Analytics’ and ‘Audit Quality Control Procedures’.

Working with firms at a global level to encourage a constant focus on improving audit quality across global firm networks: The FRC is an active member of the International Forum of Independent Audit Regulators (IFIAR). This includes membership of IFIAR’s Global Audit Quality Working Group (the FRC has the Vice-Chair role), which co-ordinates dialogue with the largest global firm networks on audit quality matters. IFIAR itself also has a target in place across the top six global firms to reduce findings reported in IFIAR’s Annual Inspection Survey by 25% by 2019.

Audit committees also have an important role in promoting improvements in audit quality. In recognition of this the AQR team has increased the level of engagement with audit committees as part of its routine inspection work. On most audits subject to an inspection, a discussion is now held with the audit committee chair at the outset of the task which provides an opportunity to influence the nature and focus of the inspection. Audit committee chairs are also invited to have a discussion on AQR findings at the conclusion of the inspection. Such discussions are particularly valuable where there are critical findings as it helps the audit committee to understand more clearly the nature of the issues in order to develop an appropriate strategy for addressing them.

We have also updated the ‘Guidance On Audit Committees’ to draw attention to the need to consider the significance of any findings from an AQR inspection and, where appropriate, to make disclosures in the annual report and accounts in relation to the nature of the issue and the action taken in response by the auditors and committee.

In the UK, the last reported full-year results on FRC inspections of FTSE 350 audits were included in the FRC’s ‘Developments in Audit’ report published in July 2016, covering inspections carried out over the 2015/16 year. At that point, 77% of audits were categorised as either good or requiring limited improvements (the previous year’s comparison was 70%). So that showed a good direction of travel. Up-to-date figures for 2016/17 will be published in the summer of 2017.
How does the FRC plan to monitor the work of actuaries alongside the Institute and Faculty of Actuaries?

The FRC oversees the Institute and Faculty of Actuaries (IFoA) on a non-statutory basis via a Memorandum of Understanding between the FRC and the IFoA. We expect the IFoA to seek assurance on the quality or otherwise of actuarial work. In order to be effective, such assurance would necessarily include a proportionate and risk-based element of random sampling of the types of actuarial work that could significantly impact the UK public interest.

The IFoA does not currently undertake direct sampling of actuarial work but is developing its approach to quality assurance. Our oversight role is thus to challenge the IFoA’s proposed approach in the UK public interest, highlighting potential gaps and seeking early deliverables to the extent that these are possible. Through its collaborative relationships with sectoral regulators in the Joint Forum on Actuarial Regulation, the FRC is also facilitating dialogues with other regulators about how they might support the IFoA’s quality assurance initiatives to make these more effective.

We report annually on IFoA’s actuarial oversight activities and its priorities. Through the mechanism of public reporting, the FRC intends to report on the IFoA’s progress with its quality assurance initiatives and on any significant gaps in this for the public interest.

Finally, please note that whilst most of the actuaries in the UK are IFoA members, ‘actuary’ is not a prescribed term. Therefore the discussion here about actuarial work in the public interest only concerns the work that is carried out by IFoA members.
Artificial intelligence: panacea or paradox?
Artificial intelligence: panacea or paradox?

Artificial intelligence (AI) is all pervasive. For example, if you bought a car recently you might have noticed the extent to which the cars on offer are ‘smart’. Perhaps your car can park for you. Perhaps it can calculate the best route based on traffic information and your driving preferences. Maybe it can even offer to wake you up if it senses you getting sleepy.

AI helps to make all this possible. But is it at all possible to define what it is?

The application of AI is developing rapidly. It offers exciting possibilities for us all, including accountants and auditors. But there are risks, both ethical and practical.

If AI helps to optimise Audit Data Analytics (ADA), then accordingly the merits of ADA are enhanced.

As AI is introduced into audits, we need to address the transparency and auditability of the AI algorithms.
We need a shared frame of reference on AI before we can discuss its merits and flaws. One of the challenges we face is that there is a lack of consensus, amongst academics and commercial practitioners, as to precisely what AI actually is.

The best place to start is with the primary goal of AI, which has remained constant since John McCarthy\(^8\) first coined the term in 1955. The goal was to create an ‘intelligent machine’ displaying cognitive functions that humans typically associate with other human minds (such as the ability to learn, plan, reason, communicate in natural language and represent knowledge).

We can also refer to current reportage on the subject of AI which includes:

- **Machine Learning**: Learning systems that are not programmed, per se, but evolve through interaction with either data, or with human experts directly.

- **Natural Language Processing (NLP)**: NLP systems can read information and instructions in a form which is understandable by humans (e.g., speech, text dialog, documents, web pages and the like) and then take meaning from it.

- **Vision**: AI systems are capable of processing extraordinary amounts of visual information and then acting on it (often in near real-time e.g., the technology making autonomous cars possible).

And finally, but by no means least, there are the mathematical principles of AI. These have been around for decades. Indeed, Alan Turing\(^9\) developed tests for intelligence in machines back in the 1950s. But the rate of progress was intermittent until very recently. The current re-emergence is owed to the astonishing computer power now available combined with advances in mathematics and AI science, enabled by vast amounts of data. In fact, it is no exaggeration to say that data is the lifeblood of AI, and we are all producing copious amounts of the stuff every day thanks to smartphones, ‘the cloud’, connected homes and web usage. By 2020, 85% of customer interactions will be managed without a human, according to independent research by Gartner.\(^{10}\)

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8. John McCarthy (1927 – 2011) a professor emeritus of computer science at Stanford University USA, created the term ‘artificial intelligence’ and was a leading figure in computer science. He developed the programming language LISP, played computer chess via telegraph with opponents in Russia and invented computer time-sharing.

9. Alan Turing (1912 – 1954) a computer scientist, mathematician, logician, cryptanalyst and theoretical biologist. Formalised the concepts of algorithm and computation with the Turing machine, considered to be a model of a general purpose computer. During World War II he worked for the UK Government Code and Cypher School (GC&CS) at Bletchley Park.

Auditors’ panacea – the practical benefits

In describing the audit of the future we talk about how AI will help us to analyse a company’s data sets (referred to as Audit Data Analytics (ADA)): helping us to ‘spot the needle in the haystack’. AI helps us to analyse electronically more information than ever before, including ‘unstructured data’ (e.g., documents and records such as company contracts).

Therefore, if AI helps the profession to optimise ADA, then accordingly the merits of ADA are enhanced. The Financial Reporting Council (FRC) reached its own conclusions on this subject, stating that: ‘The ADA we have seen in practice offers the potential to improve audit quality in a number of ways, including: deepening the auditor’s understanding of the entity; facilitating the focus of audit testing on the areas of highest risk through stratification of large populations; [and] aiding the exercise of professional scepticism...’11

In a survey of 800 executives, conducted by the World Economic Forum, 75% believed that by 2025 30% of corporate audits are expected to be performed by AI.12

At EY we are combining a company’s internal data sets with external data about the same company (e.g., customer sentiment and information about local operational issues, via surveys and buying habits respectively). This changes the audit approach: instead of relying on management estimates, judgements and data, we can independently rebuild a picture of a company’s expected performance and value from the ground up, to support our discussions and audit procedures. This is especially important where the auditors are seeking to understand the rationale for complex estimates and judgements such as asset impairment, environmental provisions or exposure to warranties and contracts.

The benefits speak for themselves. AI adds a further degree of audit independence by relying less on management and the potential risk of human bias. It also increases the scope or coverage of the audit and accordingly reduces some of the audit risks. Getting all of this right means enhancing audit quality and further augmenting the trust and reliance of those for whom the audit is conducted.

Auditors’ paradox – ethical issues

However - and this is the paradox - it is difficult to provide assurance on AI. It might also be challenging for a regulator to oversee and inspect the application of AI in the audit methodology (e.g., the underlying algorithms used to sift through and identify specific data anomalies). For example, where companies are using AI internally, an audit trail is not created in the same way that it is for more simple calculations and systems with inputs: a rule-based process and output. Likewise, where an auditor uses AI to seek out and analyse financial data, the method of approach (and underlying decisions) may not be documented and available for inspection as they once were.

Ethical issues in general

More generally, AI can lead to ‘disintermediation’ where massive amounts of data are identified and computed ‘on the fly’, to determine an action based on any number of inputs (other than human). A good example can be found in the financial markets where high frequency algorithmic trading is now common place. Real-time decisions are being made by computers, outperforming humans and (in a few years) perhaps replacing a large number of front office trading jobs, or changing them beyond recognition. According to the Congressional Research Service, approximately 55% of trading volume in US equity markets, and about 40% in European equity markets, is undertaken in this way.13

Another apposite example relates to personal finance. AI is likely to be behind the decisions about our financial attractiveness to a bank and, therefore, how much we can...


In addition to the benefits outlined above, the report also identified the following additional advantages to be gained from ADA: i) improving consistency and central oversight in group audits; ii) enabling the auditor to perform tests on large or complex datasets where a manual approach would not be feasible; iii) improving audit efficiency; iv) identifying instances of fraud; and v) enhancing communications with audit committees.

borrow and at what cost. It seems that asking for a second opinion, or pleading one's case, are usually taken out of the equation.

A more serious matter was highlighted last year by the New York Times\textsuperscript{14}. It was reported that algorithms are being inadvertently flawed by reflecting societal prejudices and bias. An example was given where police departments across the USA use data-driven risk-assessment tools in ‘predictive policing’. It analyses and identifies areas of high crime rates based on the number of arrests etc. Police are then directed to those areas where the higher number of officers leads to a greater volume of reported incidents and arrests, and so the situation spirals.

The paper also referenced an investigation by ‘ProPublica’. ‘It found that widely used software that assessed the risk of recidivism in criminals was twice as likely to mistakenly flag black defendants as being at a higher risk of committing future crimes (all other inputs held equal). It was also twice as likely to incorrectly flag white defendants as low risk.’

All of the above are representative of the real challenge of AI, namely how it ‘learns’ from the data it is presented with and/or the humans that interact with it. Inevitably - without some moral/ethical framework - our own bias can be inadvertently built into the AI.

**Conclusion**

AI is unstoppable. It will be a feature of our ‘customer experience’ and in almost all of our technology and communications. It will help us to redefine how finance systems operate, and how we audit the books. But there are risks ahead and we need to work out what we are prepared to trust and what we are not.

For those uses of AI that we do not trust (yet), we need more transparency and auditability so that we get a greater level of confidence that it works. Critically we need ethical codes, or at least codes and standards that can be amended to accommodate the application of AI (specifically its ‘learning’ and ‘training’ process).

Boards need to understand where AI is being adopted in their organisations and challenge their executive team accordingly. In the case of auditing, the audit committee will need to be satisfied that the application of AI in the audit process enhances rather than undermines the quality of the outcome, and likewise the regulator needs to be confident with the technology.

Above all else, we need to remind ourselves that the ‘intelligence’ we refer to here is ‘artificial’. We also need to ask ourselves whether the technology will work as originally intended, and be satisfied that unintended ethical consequences can be avoided, as far as ‘humanly’ possible.

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\textsuperscript{13} Congressional Research Service: High frequency trading: overview of recent developments, Rena S. Miller and Gary Shorter, April 4, 2016.

Questions worth asking

- What steps has the board taken to consider the use of internal and external company data in the external audit?

- What assurances will the board seek from its auditor, if AI becomes an integral aspect of the ADA methodology?

- How will the board engage with investors and other stakeholders if/when ADA and AI are used to inform the auditor’s opinion?
IFRS 16 – leases make their way onto the balance sheet
We expect the adoption of the new standard will be a significant undertaking for many companies.

The use of advanced data and analytics tools and techniques can significantly reduce the one-off implementation cost.

IFRS 16 is an accounting change that has a wider global business impact – so early education and cross-functional engagement will minimise surprises later on.

IFRS 16 – leases make their way onto the balance sheet

In January 2016, the International Accounting Standards Board (IASB) issued new requirements for accounting for leases under International Financial Reporting Standard 16 (IFRS 16). In this article we consider the implications for companies and the steps they should take to minimise the challenge of adopting this new standard: including the use of document scanning technology and data algorithms to extract key contract information quickly and efficiently in order to get a head start with their impact calculations.
IFRS 16 requires lessees to recognise most leases on their balance sheets, so we expect the adoption of the new standard will be a significant undertaking for many companies. Therefore, an early assessment of leases will be key to managing a successful implementation. Lessor accounting will remain, for the most part, unchanged.

IFRS 16 takes effect for financial years beginning on or after 1 January 2019.

Early adoption is permitted, provided the new revenue standard (IFRS 15 Revenue from Contracts with Customers) has been applied, or is applied at the same date as IFRS 16.

IFRS 16 takes effect for financial years beginning on or after 1 January 2019.  
A crowded implementation timeline

Leases Effective: 1 Jan. 2019

2016

IAS 8 disclosures (IFRS 16)

2017

Start Leases
Comparative period

2018

2019

First Leases
Annual accounts
What has changed for lessees?
Under the new standard a lease is a contract, or part of a contract, that conveys the right to use an asset (the underlying asset) for a period of time in exchange for a consideration. Lessees will have a single accounting model for all leases (i.e., there is no longer any distinction between finance and operating leases), with certain limited exemptions.

Many contracts contain a lease coupled with an agreement to purchase or sell other goods or services (i.e. non-lease components such as maintenance). For these contracts, the non-lease components are identified and accounted for separately from the lease component, except lessees can make an accounting policy election, by class of underlying asset, to account for both components as a single lease component. Lessees that do not make this policy election are required to allocate the consideration in the contract to the lease and non-lease components on a relative standalone price basis.

Are there changes for lessors?
Although the accounting by lessors is substantially unchanged from current accounting, lessors will have new disclosure requirements. However, lessors should understand how the new standard could affect their lessee-customers’ behaviour. For example, certain lessees may need shorter lease terms or a larger portion of variable payments in an effort to minimise their financial statement impact. Shorter leases and variable payments could result in unpredictable revenue for lessors and drive up costs to lessees. Lessees may request that lessors separately price non-lease components to help them allocate consideration between the lease and non-lease components. However, lessors may be reluctant to disclose this information for proprietary reasons. Although a contractually stated price may be the stand-alone price for a good or service, it is not presumed to be for accounting purposes.

What is the impact on companies?
For many companies leases play a critical role in their business operations. However, because most lease transactions (e.g., operating leases) are off-balance sheet today, accounting for leases under current lease standards does not often require a significant effort.

The new standard will require a company to do more than simply convert its existing operating lease commitments footnote disclosure to reflect lease assets and liabilities.

Its implementation could result in changes to the policies, processes, controls and IT systems that support lease accounting and possibly lease procurement, administration and tax. Companies may also wish to consider the implications for financial statements and metrics as they negotiate contracts that are, or may contain, leases. These activities will require involvement from a variety of departments across the company.

Practical matters and next steps
The level of complexity of implementing IFRS 16 will depend on a number of entity-specific factors. The scale of impact is typically driven by the volume, nature and location of operating leases and whether they contain lease and non-lease components. Through our engagement with clients working on their transition or looking to adopt IFRS 16 early, we have learned the following key lessons on how to approach the project in a pragmatic way and reduce the implementation risks:

• Perform diagnostic as soon as possible: early identification of in-scope arrangements is key. The revised definition of a lease could significantly change the portfolio of arrangements in scope. Consideration of the completeness of the portfolio allows for improved project management focus on material priorities and ensures all relevant stakeholders are identified upfront.

• IFRS 16 is an accounting change that has a wider global business impact: so early education and cross-functional engagement will minimise surprises to/from the business later. Increased awareness builds consensus and supports the business.

• Gaining an early understanding of the data challenge and impact on systems is central to the process: considering the use of advanced data and
analytics tools and techniques can significantly reduce the one-off implementation cost and support the migration to an ongoing permanent solution design.

We have helped a number of clients to get an early sight of their IFRS 16 requirements through use of technology. We have developed a quick and cost-effective approach to scanning a large volume of potential lease contracts, using optical character recognition and use of data algorithms to extract key contract information which is required in order to perform the impact calculation.

Gaining an understanding of the financial impact and sensitivity to changes is important to inform judgements on accounting: modelling the impact and considering materiality will inform the transition decision and support the definition and agreement of the changes to the accounting policy.

Only when the scope of implementing IFRS 16 is clearly understood, can the complexity and size of programme needed be assessed.

In summary, IFRS 16 is a significant change for lessees. Companies should perform a preliminary assessment as soon as possible to determine how their lease accounting will be affected. They also need to ensure they have the processes, internal controls and systems in place to collect the necessary information to implement the new standard.

Questions worth asking

- What impact will IFRS 16 have on current business operations and commercial negotiations?
- Are current lease procurement and management systems and processes fit-for-purpose in supporting lease/buy decisions?
- How and when will you communicate the accounting and wider commercial effects of IFRS 16 to internal and external stakeholders?
Behavioural modelling for higher quality auditing
Executing high quality audits continues to be our number one priority.

We share with the Financial Reporting Council (FRC) a common strategic objective to promote justifiable confidence in audit in the UK.

Expert modelling is the replication of high performance through a process of enquiry into and explication of the cognitive patterns of people who consistently produce outstanding results.

Behavioural modelling for higher quality auditing

We are committed to doing more than simply meeting our regulatory requirements and monitoring our quality control procedures. Audit quality is at the heart of our ability to serve the public interest. We believe high quality audits are an individual and collective responsibility at every level within our Assurance Practice. We recognise that this starts with the tone set by our EY UK LLP Board and contributes to our ability to grow the global EY network successfully and responsibly, while achieving our purpose of building a better working world.
Getting the groundwork right

We share with the FRC a common strategic objective to promote justifiable confidence in audit in the UK. This is why we continue to invest in developing and supporting our audit teams, so we can be a major contributor to the ongoing improvement of audit quality in general across the profession.

To keep us focused and continually investing and moving forward, we, in the UK, initiated a long-term Audit Quality Programme, linked to our EY Global Sustainable Audit Quality (SAQ) programme. Additionally, we have set up an Audit Quality Board which is chaired by the EY UK Head of Audit, and composed of the EY UK audit business leaders and monitored by the EY UK LLP Board.

Investment in our audit teams takes various forms. It includes the further use of technology and integration of certain data analytics tools, and a new innovation with the application of behavioural modelling. We have recently engaged with a team of leading external cognitive psychologists to help us identify what our highest performing auditors do well, so that our coaching programmes can help others to emulate their success.

The purpose of this ‘expert modelling’ is the replication of high performance through a process of enquiry into and explication of the cognitive patterns of people (referred to as exemplars) who consistently produce outstanding results.

Expert modelling

The process of developing the EY Expert Model began by engaging a wide group of stakeholders in a workshop to assess a sample of audits that all achieved the highest quality scores. This enabled the psychologists to draw out specific sets of outcomes that define a high quality audit for EY. Once completed, stakeholders were asked to identify a diverse group of exemplars at different levels within the organisation who consistently demonstrate an ability to deliver those quality outcomes.

We interviewed 27 colleagues across eight audit teams at partner, manager and senior level. Each interview lasted approximately two hours.

We believe that the EY Expert Model helps audit teams to understand more effectively the underlying cognitive skills that deliver strong quality outcomes (e.g., including an appropriate level of scepticism) for our stakeholders.
Outputs from these interviews formed our dynamic mental modelling which describes three sets of core cognitive skills that are fundamental enablers of performance across the EY Expert Model:

- **Purpose-led, outcome-oriented thinking (PLOT)**
- **Associated other perspectives (perceptual positions)**
- **Systems modelling (hard and soft)**

These three skills were found to be present in all EY exemplars (at varying levels of refinement) enabling them to construct rich mental models that support audit quality in a number of important ways:

1. Exemplars use PLOT to mindfully set and navigate towards outcomes, rather than mechanically following procedures. PLOT enables exemplars to develop internal representations of high quality standards for their work, which serve to guide actions and evaluate process.

2. The ability to take an ‘associated other perspective’ enables exemplars to understand, anticipate and respond to the behaviour of others in more effective ways. They utilise this skill to manage both client and team relationships, and gain a better understanding of clients.

3. System models underpin exemplars’ abilities to build an effective understanding of clients. They develop dynamic internal simulations of a client’s business that enable the auditor to be more effective in anticipating where, how and why risks may arise and identify specific evidence that helps to determine if a risk has materialised.

In the FRC’s ‘Developments in Audit Update, February 2017’ we noted that one of the five areas of the audit assessed by the FRC was insufficient auditor scepticism related to areas of significant risk, such as the assessment of potential impairments and judgements concerning material accounting treatments. We believe that the EY Expert Model helps audit teams to understand more effectively the underlying cognitive skills that deliver strong quality outcomes (e.g., including an appropriate level of scepticism) for our stakeholders.

This has implications for our training and recruitment. The former is being revised to augment our expert soft skills. The latter is aligned with the new Model so that we can continue to recruit people who are suited to our continuous improvement approach to audit quality.

In these ways we will reinforce our ability to deliver justifiable confidence in audit quality.
Questions worth asking

- How does the audit committee assess audit quality?
- What aspects of the FRC’s audit quality inspections matter the most?
- How will the audit committee compare the quality of one firm’s audits with another’s?
Section 6

Getting to grips with the Green Paper on Corporate Governance Reform
We encourage boards to discuss how they comply with s172 of the Companies Act 2006, and to assess whether they are considering these duties in a sufficiently broad way, having regard to all relevant stakeholders.

Executive pay and its reporting are areas of governance that companies, shareholders and the Government should focus on.

We do not believe a mandatory or comply-or-explain governance code for private companies would be practical or beneficial.

Getting to grips with the Green Paper on Corporate Governance Reform

In the January 2017 edition of Policy Pulse we published an article on executive remuneration. This included a brief reference to the UK Government’s Green Paper on Corporate Governance reform which was published on 29 November 2016. In this edition, we focus on the Green Paper.
The Green Paper highlighted five areas where views were invited on the case for changes to the UK’s executive pay framework for quoted companies.

From inquiry to Green Paper in 11 weeks
A Select Committee Inquiry on corporate governance was launched on 16 September 2016, against a backdrop of disquiet amongst politicians and others about the way UK companies govern themselves. This was prompted in part by the collapse of UK retailer British Home Stores, and media reports referring more generally to excessive executive remuneration. The Government’s response to these mounting concerns was to promise a detailed review — this was delivered with the publication of the Green Paper on 29 November 2016.

The key proposals
Executive pay
The Green Paper highlighted five areas where views were invited on the case for changes to the UK’s executive pay framework for quoted companies. The Government’s stated aim is to achieve executive pay which is long-term, fair and transparent, and related to performance. The five areas are:

- Shareholder voting and other rights: in particular improving shareholders’ ability to hold companies to account on executive pay and performance.
- Shareholder engagement on pay: how shareholder powers could be strengthened and how shareholders could be encouraged to make full use of existing powers.
- The role of remuneration committees: whether the effectiveness of remuneration committees could be improved (e.g. by mandatory shareholder and employee consultation or minimum experience levels for committee chairmen).
- Pay disclosure: whether new reporting requirements should be introduced (e.g., CEO to employee pay ratios and existing requirements strengthened (e.g., the disclosure of performance targets associated with annual bonuses).
- Long-term pay incentives: whether holding periods should be extended to five years and how plans could be better aligned with the long-term interests of quoted companies and shareholders.

In this article we recap on the key proposals in the Green Paper and summarise some examples of our views.

The scope of the Green Paper was relatively narrow and detailed, totalling fifty seven pages and fourteen questions on three key aspects of corporate governance: i) executive pay; ii) employee, customer and wider stakeholder engagement; and iii) privately-held businesses.
However, before discussing solutions, it is important to be clear on which issue(s) any reforms would be trying to solve. We have heard many stakeholders call for the simplification of executive pay and its reporting, and we believe that this area would be an appropriate focus for companies, shareholders and the Government.

If the Government believes that reforms to the governance framework around executive pay are needed, we believe they should focus on the 'how', e.g. the procedure behind the setting and benchmarking of executive pay policies, with the ultimate goal being that it is stakeholders (e.g., employees and shareholders) who hold companies to account for the 'what', i.e. the actual levels of pay.

We encourage boards to discuss how they comply with Section 172 of the Companies Act 2006\(^\text{15}\), to see whether this duty can be carried out more effectively.

For example, reporting against Section 172 is already included indirectly through the requirements of the Strategic Report\(^\text{16}\), but companies should think about additional ways to communicate with stakeholders and improve the overall level of engagement.

Privately-held businesses

These proposals considered the position of private companies which, in comparison with public companies, are required to comply with relatively lower governance and reporting standards. The Green Paper proposed that some form of governance code should be introduced for private companies.

We do not believe a mandatory or comply-or-explain governance code for private companies would be practical or beneficial, not least because the accountability mechanism is unclear (i.e., there will be no public ownership of the type associated with listed companies). We support the current regime, and accordingly initiatives should be focused on improving guidance on the current obligations placed upon private companies, especially those which are of public interest.

However, if the Government wishes to introduce more legislation related to private companies, the definition of a 'large-privately held' company needs to be made consistent, as it varies from regulation to regulation. It should also avoid introducing additional piecemeal regulation on related matters such as company reporting, to help reduce the regulatory burden on small companies.

Way forward

In our view, the Green Paper could have been more forward looking in light of the broader business challenges facing companies today e.g., new technologies, disruption and uncertainty surrounding Brexit and the economy. Corporate governance needs to evolve progressively to respond to these challenges, so we encourage the Government to develop proposals that are one step ahead and ensure that the UK’s already world-leading governance framework remains fit-for-purpose in this new era.\(^\text{17}\)

Our Corporate Governance team will shortly publish a paper with some reflections on future-proofing corporate governance based on a series of roundtable discussions they recently held.
Questions worth asking

- How does the board and its remuneration committee seek to ensure its remuneration policy remains fair, transparent and focused on the long-term?
- What steps does the board take to ensure it’s aware of, and receptive to, the views of its employees and other stakeholders?
- How does the board plan to keep ahead of developments in corporate governance?

15. S 172: The duty requires a director to act in the way he or she considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole. Directors also need to have regard to areas of particular importance which reflect wider expectations of responsible business behaviour, such as the interests of the company’s employees and the impact of the company’s operations on the community and the environment.

16. The Companies Act 2006 (Strategic Report and Directors’ Report) Regulations 2013 Strategic Report: This requires: i) a fair review of the company’s business, and a description of the principal risks and uncertainties facing the company; ii) the development and performance of the company’s business during the financial year, and the position of the company’s business at the end of that year; iii) analysis using financial key performance indicators, and where appropriate, analysis using other KPIs, including information relating to environmental matters and employee matters.

17. In a recent EY publication, ‘UK Corporate Governance Reform: What next?’ we examine in more detail the background and context of the Green Paper. We also provide an overview of the policy formation process and what we can expect and when from this particular initiative to reform corporate governance in the UK.
Cybersecurity wake-up call
These incidents have led to more regulatory interventions from the UK Government and supranational bodies.

The national strategy is intended to help shape the Government’s future policy, while also offering a ‘coherent and compelling vision to share with the public and private sector, civil society, academia and the wider population’ on how best to deal with cyber threats.

When advising clients, we recommend that organisations undertake a detailed review of their cybersecurity risks and posture across their people, processes and technology.

Cybersecurity wake-up call

In recent years there has been a significant increase in cybersecurity breaches impacting personal data across organisations in all sectors, even those organisations and individuals who believed they were secure. A recent example of this was the breach at Yahoo. It affected over 500 million of their customers worldwide, with serious consequences for its brand and reputation.
The cybersecurity breach at Yahoo affected over 500 million of their customers worldwide, with serious consequences for its brand and reputation.

These incidents have led to more regulatory interventions from the UK Government and supranational bodies. Two key initiatives are the development of a UK National Cybersecurity Strategy and EU General Data Protection Regulations (GDPR) respectively. They provide clear evidence of the growing concerns over cybersecurity and data privacy amongst the regulatory community. This article considers the impact of the UK Government’s position on this issue, and the steps we are taking to protect our own interests and those of our clients. For information and views on the GDPR please refer to our January 2017 edition of Policy Pulse.

The UK’s National Cybersecurity Strategy
The UK Government has declared its intention that Britain shall retain its position as one of the world’s leading digital economies. In November 2016 it launched the ‘National Cybersecurity Strategy 2016 - 2021’, as a means to support this aim and as one of the key pillars for protecting and maintaining the UK’s digital economy.

The strategy outlines the Government’s vision for moving the UK to the point where it is ‘secure and resilient to cyber threats, and prosperous and confident in the digital world’. It highlights three key objectives to help achieve this: i) to develop the ability to defend the UK from attacks and respond when attacks occur; ii) to become a hard target so as to deter the targeting of our people, business or institutions; and iii) to continue to develop a cybersecurity industry capable of providing the skills and technologies necessary to achieve the strategy over the longer term.

The strategy is intended to help shape the Government’s future policy, while also offering a ‘coherent and compelling vision to share with the public and private sector, civil society, academia and the wider population’ on how best to deal with cyber threats.
The scope of the strategy

The strategy covers the whole of the UK, and the Government emphasises that it will seek to propose or recommend actions ‘aimed at all sectors of the economy and society, from central Government departments, to leaders across industry and the individual citizen.’ It focuses on the protection of ‘information systems (hardware, software and associated infrastructure), the data on them, and the services they provide, from unauthorised access, harm or misuse. This includes harm caused intentionally by the operator of the system, or accidentally, as a result of failing to follow security procedures.’

The strategy outlines the various forms that cybercrime can take, but it considers that the most serious threats (fraud, theft and extortion) are perpetrated predominantly by ‘financially motivated Russian-language organised criminal groups in Eastern Europe, with many of the criminal marketplace services being hosted in these countries.’

The Government adds that ‘the threat also emanates from other countries and regions, and from inside the UK itself, with emerging threats from South Asia and West Africa’.

Accordingly, the Government emphasises the importance of international cooperation. To this end it states that it will seek to:

‘strengthen and embed a common understanding of responsible state behaviour in cyberspace; build an agreement that international law applies in cyberspace; and continue to promote the agreement of voluntary, non-binding, norms of a responsible state’ amongst several other aims.’

Our approach to cybersecurity

We have worked with the Government and regulators on cybersecurity improvement initiatives. These include the FTSE 350 ‘Cyber Governance Health Check Report 2015’, and the ‘Cyber Essentials’ certification programme (a Government-backed scheme to help organisations protect themselves against common cyberattacks).

Within EY we have ongoing extensive training and awareness programmes on cyber threats, in all of its various guises (both internal and external). This is in addition to a code of conduct and related policies on IT matters, requiring individual employees to abide by various security and ethical requirements. These apply to all EY employees and they are backed-up with technical security and surveillance measures.

When advising clients we recommend that organisations undertake a detailed review of their cybersecurity risks and posture across their people, processes and technology to understand the threats most relevant to their organisations and the associated effects on their businesses. Understanding critical digital assets and how they could be compromised is a key enabler for improving cyber preparedness and resilience capabilities.

In this regard, we believe there is much more work to be done. For example, according to the feedback we receive from companies, approximately 80% of them have only just begun to prepare for the adoption of the GDPR, with just over a year to go until the regulations take effect in the UK.

Our 19th Global Information Security Survey (2016/17) of 1,735 CIOs found there is scope for improvement in the way most companies manage their cybersecurity risks.

In conclusion, organisations need to take account of the increasing cyber and data privacy regulations and aim, as far as possible, to improve their preparedness for whenever these regulations change. In other words, don't wait to be told what to do. Do what needs to be done now.
Questions worth asking

- How does the board plan to ensure that all available means have been deployed to protect the business from cyber threats?
- How is data - personal or otherwise - collated, stored and retrieved with the minimum amount of vulnerability to a cyberattack?
- What steps has the board taken to ensure that a cyberattack, if/when it occurs, can be detected and reported to the appropriate authorities with immediate effect?

87% of board members have said they lack confidence in their organisation’s level of cybersecurity.

57% of respondents have had a recent and significant cybersecurity incident.

42% do not have an agreed communications strategy or plan in the event of a significant attack.
Recent regulatory developments worth watching

December to March 2017
The Financial Reporting Council (FRC) published its draft plan and budget for 2017

The FRC included references to the UK Government’s Green Paper on Corporate Governance Reform, and the need to consult on what could be significant changes to the UK Corporate Governance Code. In addition to its work on corporate governance, the FRC plans to enhance the speed and effectiveness of its enforcement role. It is aiming to promote clear and concise corporate reporting whilst promoting justifiable confidence in audit, through its role as the UK’s Competent Authority for audit. It is also planning to promote high quality actuarial work by seeking to develop technical actuarial standards. It stated that its budget for 2017/18 requires a 4% increase in overall funding, principally through an increase of 2.5% in the levies on the professional bodies and a 5% increase in the preparers levy.

The Financial Reporting Council (FRC) published its review of corporate governance and stewardship in the UK for 2016

The FRC found that 90% of FTSE 350 companies reported their compliance with all but one or two of the UK Corporate Governance Code’s provisions. However, they noted that explanations for non-compliance were mostly unsatisfactory, and some investors were concerned about a lack of transparency in relation to the linkage between executive remuneration and performance. The FRC’s inspection of the UK Stewardship Code signatories, and introduction of tiers to indicate which ones were more compliant with the Code, resulted in approximately 80 signatories improving the quality of their statements of compliance, moving from Tier 2 into Tier 1.

Review of Audit Data Analytics (ADA) by the Financial Reporting Council (FRC)

The FRC assessed the use of ADA in the course of conducting audit quality inspections in 2016, to identify examples of good practice. Examples of their findings included firms that enabled audit teams to build their experience and confidence in ADA through structured roll-out programmes. They referred to the use of ADA at interim audit dates, to improve the prospect of obtaining robust audit evidence at the financial year end. Firms were also praised for improving the effectiveness and efficiency of the extraction of entity data into ADA tools, by using dedicated specialist staff and/or dedicated software. Concerns were raised however because some firms were not actively monitoring the level of ADA usage by their audit teams, and whether the use of these tools were successful in providing appropriate audit evidence.
UK Government’s White Paper on Brexit

The Department for Exiting the European Union issued a White Paper on the UK’s exit from the EU. The White Paper referred to a new partnership with the EU and set out the basis for the UK Prime Minister’s negotiating priorities. It also covered a wide range of regulatory issues including commercial law, crime, financial services, employment, environmental law, immigration and international trade. In broad terms, the White Paper stated that the Government is aiming for the freest possible trade with the use of a phased process of implementation, to allow the UK and the EU to prepare for the new arrangements that will apply following the UK’s departure from the EU.

Financial Reporting Council (FRC) issues updated guidance on audit tenders

The FRC has updated its guidance on audit tenders. The key revisions were wide ranging. Four examples are provided as follows: i) Where it is not clear when an audit engagement began, the FRC will give an opinion; ii) Entities that use several firms for different advice should develop a long-term strategy which ensures that at least two firms are able to participate in the audit tender process and satisfy auditor independence requirements; iii) All members of the audit committee should have a good understanding of the legal requirements, the mechanics of a tender process and what the company is trying to achieve from the process; and iv) All members of the audit committee should be involved throughout the tender process.

Financial Conduct Authority (FCA) reviews the UK’s primary markets

The FCA published a Discussion Paper and a Consultation Paper in connection with its plans to review the effectiveness of the UK primary markets. The FCA seeks views, amongst other things, on whether the current division between standard and premium listing is still relevant, especially in relation to overseas issuers. It also explores measures that might be taken to improve the effectiveness of UK-listed primary debt capital markets. In particular, it focuses on the question of whether there is an opportunity in the UK for a new wholesale bond multilateral trading facility. The FCA is also considering whether, for example, premium listing eligibility requirements need clarifying and concessionary routes to premium listing need to be updated.
Audit quality report called ‘Developments in Audit’ was published by the Financial Reporting Council (FRC)

In this update the FRC proposes to review the effectiveness of the governance and culture of audit firms, with emphasis on the public interest role of their independent non-executives. It also announced that it will publish lists periodically of those entities whose audits it has inspected. The FRC expects increased reporting, by the audit committees of these entities, on the findings of these inspections with a corresponding increase in investor interest and scrutiny. The FRC also stated, amongst other concerns, that insufficient auditor scepticism was identified in the last round of audit inspections. This related to areas of significant risk, such as the assessment of potential impairments and judgements concerning material accounting treatments.

The UK Corporate Governance Code is to be reviewed in 2017 by the Financial Reporting Council (FRC)

The review will cover, amongst other things, its work on corporate culture and issues it raised in response to the UK Government’s Green Paper on Corporate Governance Reform. To guide this review the FRC will seek input from a wide range of stakeholders including its recently established Stakeholder Advisory Panel of high profile representatives from a wide variety of sectors. In its response to the Green Paper the FRC highlighted: the importance of helping boards to take better account of stakeholder views linking executive remuneration with performance, and extending the FRC’s enforcement powers to ensure that disciplinary action can be taken against all directors where there have been financial reporting breaches.

UK Government Green Paper on Corporate Governance Reform: the Financial Reporting Council (FRC) response

The FRC published its response to the Green Paper. It put forward various views including: i) The duty placed by the Companies Act 2006 on directors of all companies to promote the success of the company (including the reporting of this) must be reinvigorated; ii) The role and remit of the remuneration committee should be extended to cover pay policies throughout the organisation; iii) Large private companies must be more accountable to their stakeholders, given their significance to the public interest and the privilege and benefits of limited liability status; and iv) The FRC seeks to extend its powers to investigate and prosecute all directors for financial reporting breaches and associated issues of integrity, rather than only accountants and actuaries.
The UK Government introduces the Criminal Finances Bill

The Bill had its first reading in the Houses of Parliament on 22 February 2017. It seeks to address corporate failures to prevent tax evasion by introducing two new criminal offences: firstly, the domestic fraud offence which criminalises corporations, based anywhere in the world, that fail to put in place reasonable procedures to prevent their representatives from criminally facilitating tax evasion and secondly, the overseas fraud offence which criminalises corporations carrying out a business in the UK who fail to put in place reasonable procedures to prevent their representatives from facilitating tax evasion in another jurisdiction.

Audit quality thematic review: firms’ audit quality control procedures and other audit quality initiatives — a report published by the Financial Reporting Council (FRC)

The FRC issued this review to present good practice in audit quality control procedures. The context for doing this was that a third of audits sampled by the FRC for the review required more than just limited improvements. The FRC concluded that the quality control procedures adopted by these firms had not been effective. Areas of good practice outlined by the FRC include the use of dedicated boards or committees that oversee all matters relating to audit quality. Areas in need of improvement include the need for the involvement of specialists in the audit with sufficient reporting of their work, and better use of findings from root cause analysis to enhanced procedures for controlling audit quality.

Information Commissioner’s Office (ICO) issues updated guidance on big data, artificial intelligence, machine learning and data protection

The ICO’s guidance was issued to coincide with increased usage of data analytics across all sectors and the implementation of the EU’s General Data Protection Regulation (GDPR), which takes effect from May 2018. The guidance covers the practicalities of conducting Privacy Impact Assessments (PIAs) in a big data context, as a requirement of the GDPR. The ICO recommends that entities also undertake the following to comply with the GDPR: i) the anonymisation of personal data; ii) the use of appropriate privacy notices; iii) the development of ‘privacy by design’; iv) the development of ethical principles; and v) the application of auditable machine learning algorithms.
UK Government Equalities Office and ACAS issued final guidelines for the introduction of gender pay gap reporting.

The document explains what the new regulations — effective from April 2017 — require of entities within scope (i.e., UK incorporated entities with 250 or more employees). It explains, for example, that employers need to publish on their external website their: i) mean and median gender pay gaps; ii) mean and medium bonus gender pay gaps; iii) proportion of males and females receiving a bonus payment; and proportion of males and females in each pay quartile. Alongside these figures, if the entity is a business or charity, it must also publish a written statement, which must confirm that the published information is accurate (to be signed by a director or appropriate person).

HM Treasury: Money Laundering Regulations 2017

HM Treasury is seeking further views on the UK’s transposition of the Fourth Anti-Money Laundering Directive, together with the draft Money Laundering, Terrorist Financing and Transfer of Funds Regulations 2017, following its initial consultation in 2015. The key points HM Treasury is investigating include changes to: i) beneficial ownership; ii) reporting obligations; iii) changes to the supervisory regime; iv) administrative sanctions and criminal penalties. HM Treasury aims to have the regulations in place by 26 June 2017.

Competition and Markets Authority (CMA) guidance on initial enforcement orders and derogations in merger investigations

The CMA is reviewing its guidance in relation to the use of Initial Enforcement Orders (i.e., requirements that forbid two parties from merging at a particular moment in time) and the derogations that might be granted to companies that are planning to merge. The guidance is intended to help merging parties and legal advisers to consider whether a derogation request is necessary and whether it is likely to be granted.
**Content contributors**

For further information on any of the issues raised here, please contact one of the following content contributors or your usual EY adviser:

**Defining more effective measurement and reporting of a company's value**

Hywel Ball  
+44 (0)20 7951 2474  
hball@uk.ey.com

**Artificial intelligence – panacea or paradox?**

Ben Taylor  
+44 (0)20 7951 6481  
btaylor2@uk.ey.com

**IFRS 16 – leases make their way onto the balance sheet**

Herman Heyns  
+44 (0)20 7951 6051  
hheyns@uk.ey.com

**Behavioural modelling for higher quality auditing**

Bob Forsyth  
+44 (0)20 7951 6817  
bforsyth@uk.ey.com

**Getting to grips with the Green Paper on Corporate Governance Reform**

Mala Shah-Coulon  
+44 (0)20 7951 0355  
mshahcoulon@uk.ey.com

**Cybersecurity wake-up call**

Richard Brown  
+44 (0)20 7951 4090  
rbrown@uk.ey.com

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