
Audit Committee Network update Spring 2018 summary

June 2018



Contents

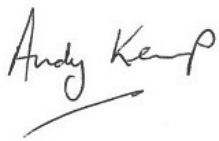
<i>Accounting update</i>	2
<i>Corporate reporting/governance matters</i>	4
<i>'Total Impact of Internal Audit' ('TIIA')</i>	9
<i>Tax transparency and the rise of digital tax authorities</i>	12

Introduction

PwC's Audit Committee Network provides audit committee chairs and members with a series of workshops to help address the need to keep up to date with Board level issues. This document summarises the discussions arising from the spring 2018 Audit Committee Network events.

We started the sessions with an **accounting** overview, which covered IFRS 16 and a discussion around the use of IFRS after Brexit. This was followed by a **corporate reporting/governance update** and an outline of the proposals set out in the Corporate Governance Code consultation. We then introduced a new framework called '**Total Impact of Internal Audit**', which is designed to help get the best out of your Internal Audit function. We concluded with a discussion around the potential impacts arising from the **digitisation of tax authorities** around the world.

I hope you find this summary useful. For more information on any of the topics, contact details can be found at the end of this document.



Andy Kemp

Chair, Audit Committee Network

Accounting update

IFRS 16

IFRS 16 Leases requires lessees to recognise nearly all leases on the balance sheet and is effective 1 January 2019.

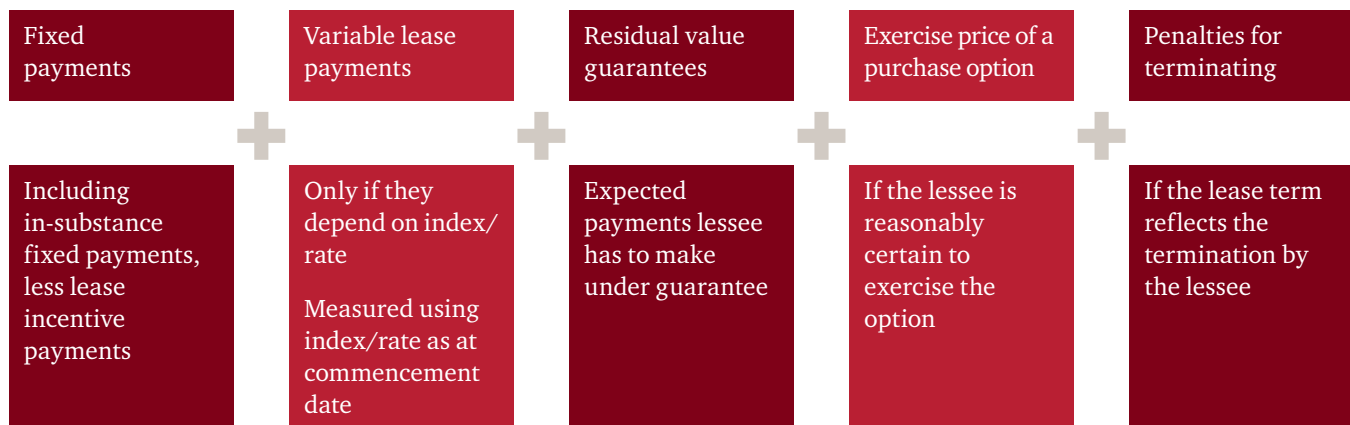
Headlines

- All lease liabilities are recognised on balance sheet, although there are exemptions for short term leases (less than 12 months) and leases of low value assets.
- The standard provides additional (and different) criteria for identifying whether contracts contain leases.
- There is also more guidance on lease term and variable rent, and enhanced disclosure requirements compared to IAS 17.
- Lessees will present interest expense (on lease liability) and depreciation (on right use asset) instead of an operating lease 'rental' expense, which will impact EBITDA.
- The part of the lease payment that represents cash payments for the principal portion of the lease liability is presented as a cash flow resulting from financing activities. The part of the lease payment that represents interest portion of the lease liability is presented either as an operating cash flow or a cash flow resulting from financing activities (in accordance with the entity's accounting policy regarding the presentation of interest payments).
- Lessor accounting remains largely unchanged from IAS 17; however, lessors are expected to be affected due to the changed needs and behaviours from customers which impacts their business model and lease products.
- A lessee has to choose either a full retrospective approach or a modified retrospective approach to transition to the new standard. The selected approach has to be applied to the entire lease portfolio.

Measurement of lease liability

The lease liability is a present value of the lease payments during the lease term and is measured by discount using the interest rate implicit in the lease, if it can be readily determined. If it cannot be determined, the lessee must use its incremental borrowing rate. Determining the incremental borrowing rate might be a significant practical challenge.

Lease payments that should be included in the liability are:



Why does it matter?

IFRS 16 will have an impact on most companies, but the most significant increases in debt and EBITDA are likely to be seen in retailers, airlines and professional services. It not only represents a significant accounting change for leases, but could also have an impact on:

- A company's systems and also changes to processes.
- A potential trigger of covenants breaches.
- More explanation to investors around numbers.
- Planned deals (debt, IPO, M&A) and how the financials will look.
- KPIs and the resulting knock on effect on remuneration schemes.
- Lessee behaviours and the subsequent effects on lessors.

Questions to ask management

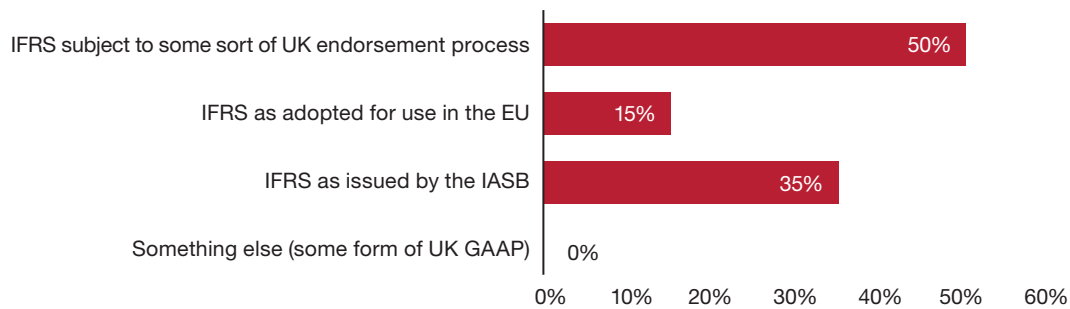
1. Do you know how many leases you currently have, or where the agreements are? If not, how will you identify them all? How are you going to manage all the data in a consistent fashion?
2. What are the key policy choices, judgments and estimates to be made upon transition?
3. How will KPIs be impacted? What will this mean for covenants, investor communications, remuneration arrangements, etc.?

Use of IFRS after Brexit

Under EU Regulation 1606/2002, all listed companies in the EU are required to report under EU-adopted IFRS. In March 2019, the UK will be exiting the EU and this will have an impact on how companies prepare their group financial statements. We asked a number of questions to our event attendees to gauge their opinions. The results are as follows:

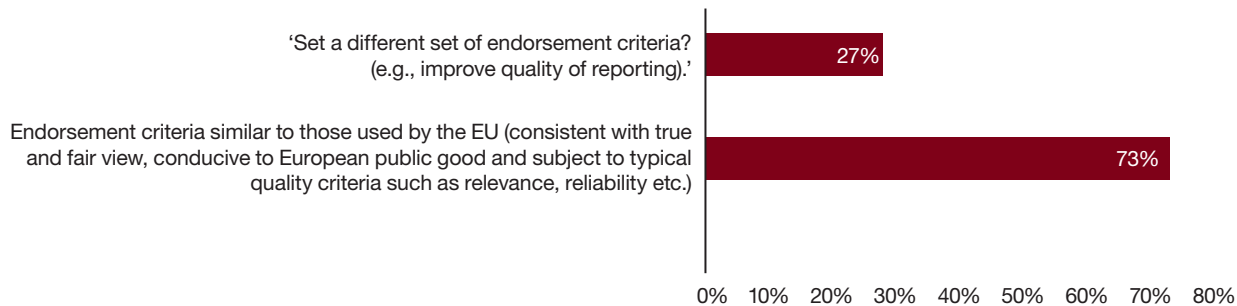
Question 1

Which of the following options is preferable for reporting by listed groups after Brexit?



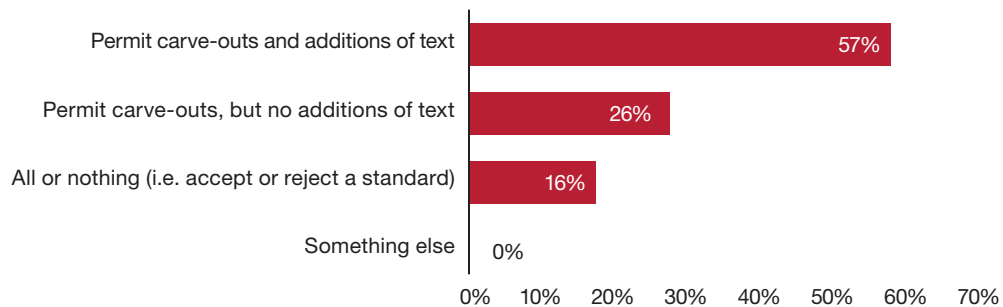
Question 2

If the UK were to create its own endorsement process, which of the following would be preferable?



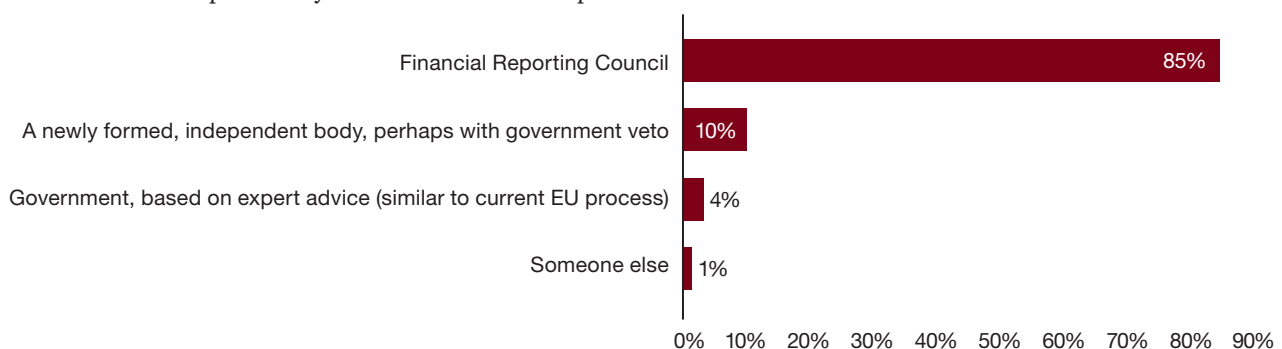
Question 3

What should be the power of the endorsement body with respect to a new standard?



Question 4

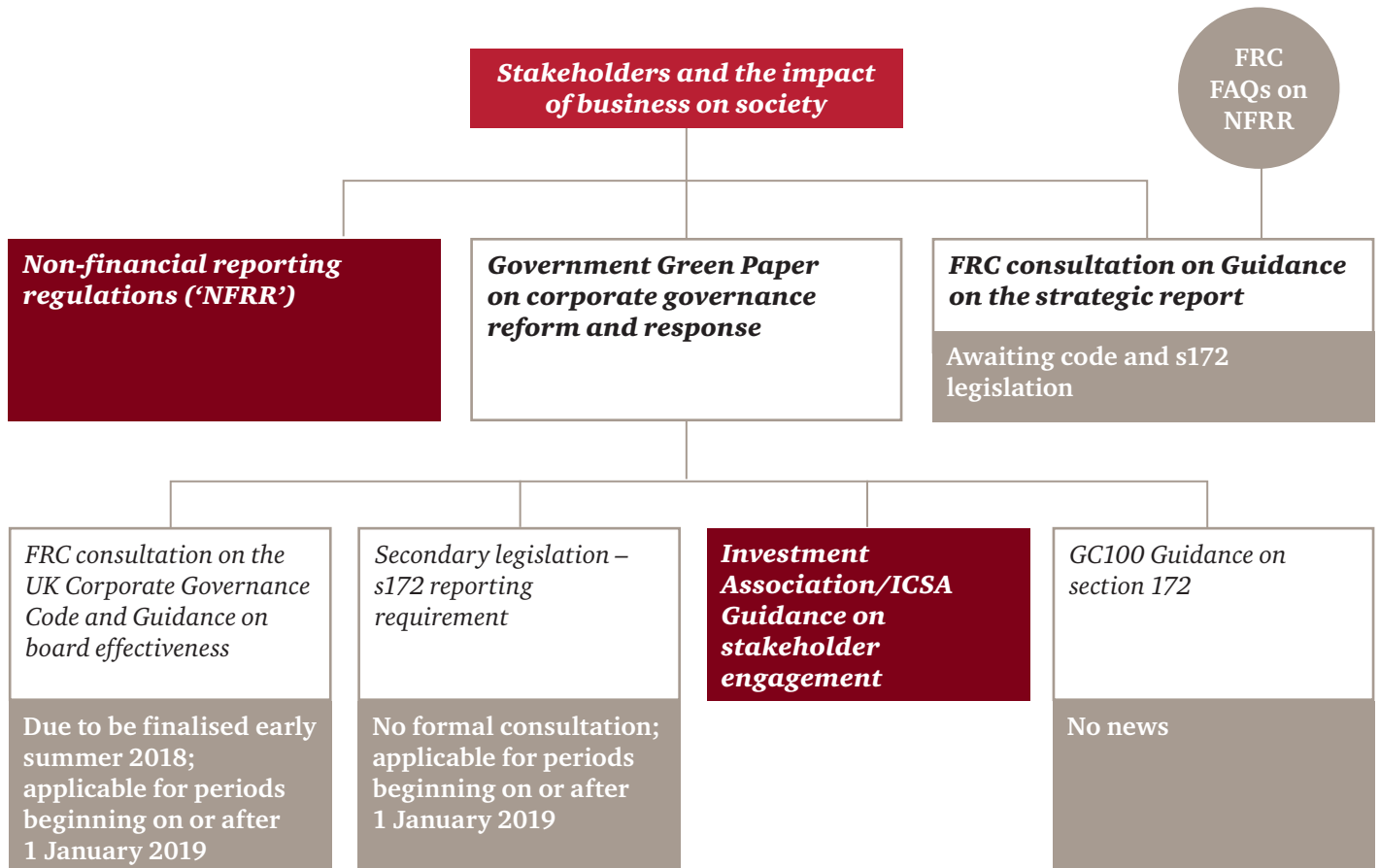
Who should have responsibility for a UK endorsement process?



Corporate reporting/governance matters

Our corporate reporting/governance update focussed on an update around the developments centred on the stakeholder agenda, and principally the FRC's consultation on its review of the UK Corporate Governance Code.

The session began with an update of the principal developments to be aware of:



Key

Final

Still subject to consultation/
or not yet issued

During the session attendees were updated on what we have seen so far in relation to the new non-financial reporting regulations and diversity reporting under the Disclosure and Transparency Rules. It was felt that many companies had more to do in both of these areas.

In addition to these developments, other governance reforms to be aware of included the following:

<p>Governance and private companies</p>	<ul style="list-style-type: none"> • A new set of principles to be developed by group chaired by James Wates, including the FRC, IoD, CBI, BVCA, IA and ICOSA • Likely to be enforced through new reporting in directors' report and on the company's website, on a comply-or-explain basis • Thresholds could be high (Green Paper suggested >2,000 employees) 	<p>Could apply <i>Periods beginning on or after 1 January 2019</i></p>
<p>Changes to AIM Rule 26 on governance</p>	<ul style="list-style-type: none"> • This will require AIM companies to apply a recognised governance code • Companies will be required to report against it on a comply-or-explain basis on the company's website • They will also need to explain how it has been applied 	<p>Comply <i>By 28 September 2018</i></p>
<p>Section 172 reporting regulations</p>	<ul style="list-style-type: none"> • Reporting promised in Green Paper – overlaps with Code for relevant companies • This will need to be reported through the strategic report and on the company's website • Private AIM companies would be affected – thresholds to be confirmed but could be relatively low • Could be separate reporting on stakeholder engagement 	<p>Could apply <i>Periods beginning on or after 1 January 2019</i></p>

BEIS has recently informally consulted on the governance and private companies and section 172 reporting regulations (which would be part of the Companies Act) and a consultation from the Wates group is expected later in the year; the London Stock Exchange made the changes to the AIM Rules noted above in March.

FRC consultation on UK Corporate Governance Code

In December 2017, the FRC released its proposals for revisions to the UK Corporate Governance Code and Revised Guidance on Board Effectiveness for consultation, which closed in February 2018.

A reminder of some of the more significant proposals is set out below. Good debates were had on many of these areas, and the most controversial aspects are indicated.

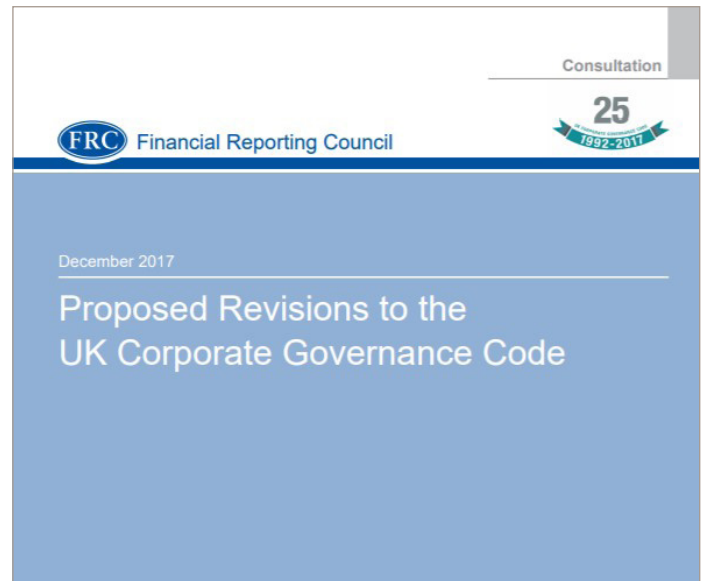
Structure

- The intention is to make the revised Code 'shorter and sharper' – it has been reduced from 55 to 41 provisions.
- There have been changes to the structure of the Code: the main principle/supporting principle distinction has been removed.
- Some elements of the previous Code have been incorporated into the 'Revised Guidance on Board Effectiveness'.

Reporting

- There is a significant proposed shift in emphasis towards how a company has applied the principles to avoid 'boilerplate' reporting.
- The Code consultation puts more emphasis on a how a company should articulate action taken and resulting outcomes should be described.

It is important to report meaningfully when discussing the application of the Principles and to avoid boilerplate reporting. Instead, focus on how these have been applied, articulating what action has been taken and the resulting outcomes. Good practice examples of reporting will include signposting and cross-referencing to those parts of the annual report that describe how the Principles have been applied; this will help investors with their evaluation.



Engagement

The consultation document makes it clear that the board will be expected to consider the culture of the company and wider stakeholder interests to achieve long-term sustainability. The draft Code sets out the three approaches to gathering views of the workforce that were suggested in the Government's response to the Green Paper:

- a director appointed from the workforce;
- a formal workforce advisory panel; or
- a designated Non-Executive Director.

Companies will have flexibility to choose an alternative mechanism and, as long as this delivers meaningful, two way dialogue, the Code requirement will be met. Companies are already responding to the new emphasis on stakeholder engagement and, from our reviews of 2017 annual reports to date, a formal advisory panel appears likely to be the most frequent approach (though there is evidence for the others too).

There is also provision in the revised Code to have boards report on how they have engaged with the workforce and other stakeholders and how their interests and the other matters set out in Section 172 of the Companies Act 2006 influenced the board's decision-making. This provision is subject to change as the Companies Act reporting regulations discussed earlier are finalised.

Independence of Non-Executive Directors and chairs

This is perhaps the area of change which has provoked the most widespread debate and which was most commented on in the responses the FRC received to their consultation document.

Under the existing Code, whether a Non-Executive Director is regarded as independent is a matter for the judgement of the board. The FRC is now proposing to remove this judgement – so that, for example, a director who has been on a board for more than nine years since the date of their first election can no longer be regarded as independent.

Related changes are proposed for the status of the chair of the company. Previously, the chair has been deemed not to be independent from the date of appointment as chair, due to the extent of his or her involvement in the company's business. The FRC is proposing to change this and, under the draft Code, the chair will now be subject to the same independence criteria as other Non-Executive Directors.

Small companies

The revised Code proposes to remove the relaxations for companies outside of the FTSE 350, which include:

- The number of independent non-executives on the audit and remuneration committees.
- Externally facilitated board evaluations at least every three years.
- Annual re-election of all directors.

This has also been controversial in some sectors of the market, including among investment companies.

Company purpose and 'contribution to wider society'

Principle A of the proposed new Code requires boards to establish the company's purpose and puts contributing to wider society at the same level as generating returns for shareholders. Some investors have questioned this and there has been significant discussion as to whether it goes beyond section 172.

Remuneration

The draft Code requires the remit of the remuneration committee to be expanded to include the setting of remuneration of the board and senior management. The remuneration committee is also expected to have oversight of workforce policies and practices.

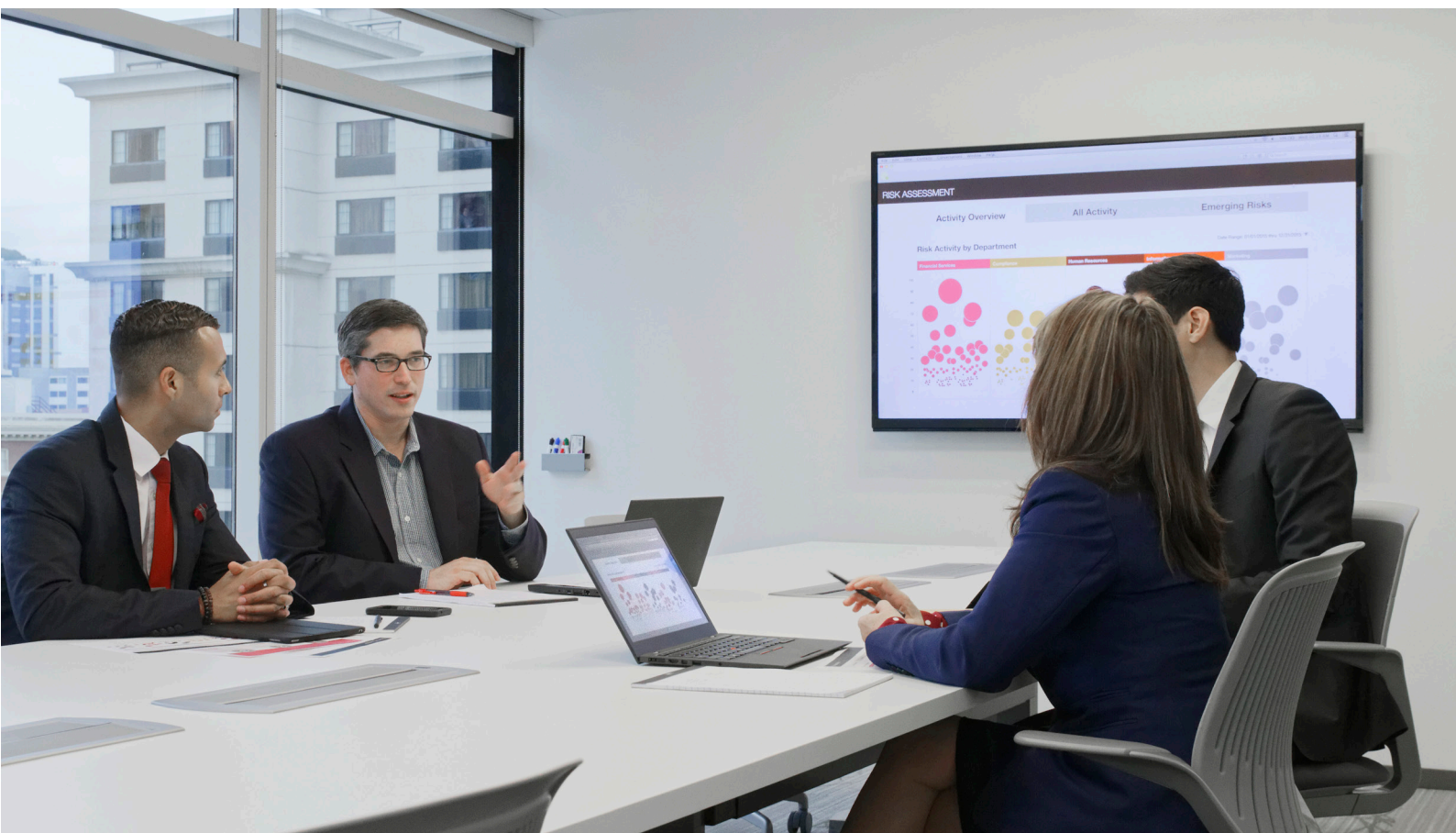
There is also a new provision requiring a minimum five year period (from grant to realisation) for long-term incentives and longer periods (including post-employment) where appropriate.

Reporting on cases of 'significant dissent' against AGM resolutions

The draft Code also addresses shareholder engagement, following a significant vote (now set at 20%) against a general meeting resolution. In addition to the current requirement to make a statement when announcing the voting results, there is a new requirement to provide an update no later than six months after the relevant vote on the company's understanding of the reasons for the dissent.

Committee chair engagement

Committee chairs should engage with shareholders on 'significant matters' relating to their areas of responsibility, something which is likely to be of particular relevance to audit committee chairs. However, 'significant matters' are not defined in the consultation document.



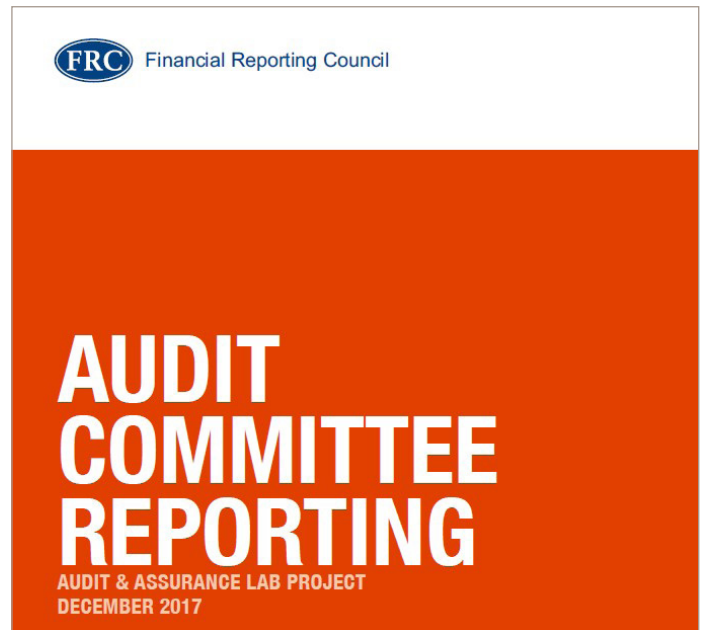
FRC Audit and Assurance Lab Audit Committee Reporting

The FRC has published the first report from its Audit and Assurance Lab, 'Audit committee reporting'. This is the first part of a planned two-stage project and relates to the audit committee section of the annual report: the second part will focus on auditor reporting to audit committees.

Some key messages from the report

- The report emphasises the importance of the audit committee's role in the view of many investors.
- Investors value the role played by the audit committee and place reliance on its work.
- Both audit committee chairs and investors recognise that there is scope for further engagement (this is also encouraged in the proposed new UK Corporate Governance Code).
- The audit committee report can be seen as an indicator of the quality of the committee's work, so has the potential to build trust and confidence among users.
- Audit committee chairs and investors overwhelmingly agree that audit quality should be a key factor in the audit tendering selection process.
- Investors would like to see more explanation around an audit committee's non-audit services assessment.

The report also includes a number of questions for audit committees to ask and good practice examples in areas including auditor appointment and tendering, independence and effectiveness, significant issues and risk management and internal control. Feedback from audit committee chairs who have used the report has been positive.



‘Total Impact of Internal Audit’ (‘TIIA’)

Every year, PwC runs a ‘State of the Internal Audit Profession Survey’, which supports the PwC view that stakeholders expect more from Internal Audit. This raises the question: if Internal Audit stakeholders expect more, how does the Internal Audit profession rise to the challenge, deliver more and prove their value?

To help better articulate the value and measure the impact of the Internal Audit function, PwC has created and validated ‘Total Impact of Internal Audit’ or ‘TIIA’. TIIA is a PwC framework for directing and measuring the holistic contribution of Internal Audit where: Total Impact = Effectiveness + Contribution.

PwC introduced the ‘Eight attributes of Internal Audit excellence’ in 2010 to help Internal Audit deliver on its primary role of providing confidence and assurance.

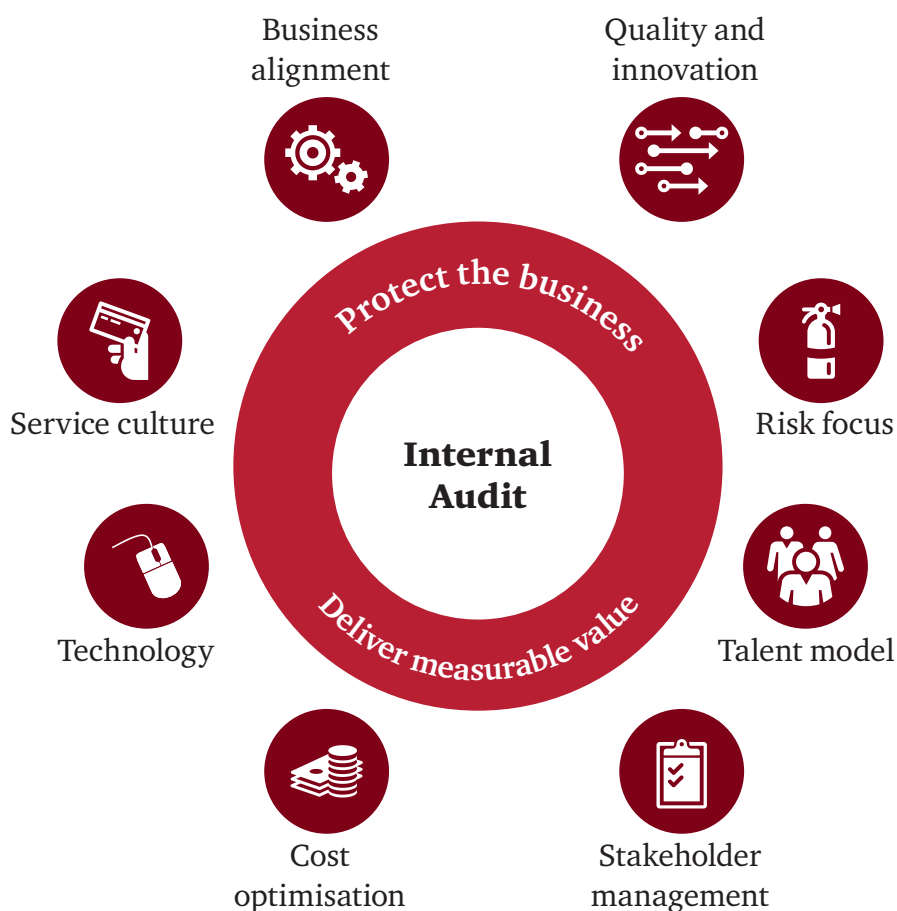
However, key functions, including Internal Audit, are facing increasing pressure to justify the value they deliver over and above fulfilling their function of providing Confidence and Assurance. This is a challenge because there is a lack of a consistent or recognised framework to measure the contribution, impact and value of Internal Audit.

The genesis of TIIA

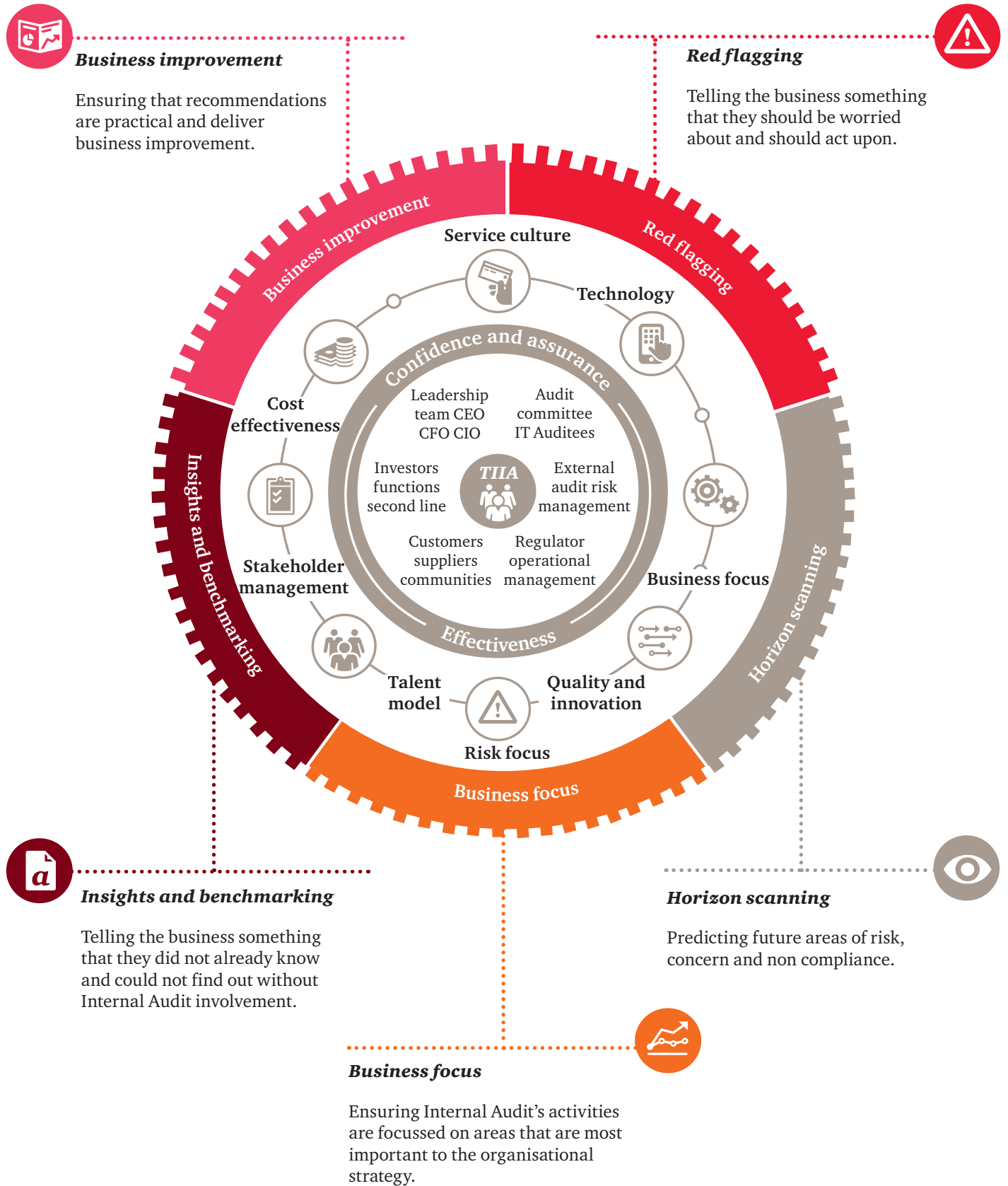
TIIA was inspired by the previous PwC framework ‘Total Impact Measurement and Management’ which measured the impact an organisation has on its environment, people, local economy and infrastructure.

TIIA was created by identifying Internal Audit’s direct and indirect stakeholders and by using the expectations of these stakeholders, which was then summarised into Contribution Domains. These contribution measures were then reviewed by Heads of Internal Audit and using the feedback, were amended accordingly.

Eight attributes of Internal Audit excellence



TIIA framework



Insights and benchmarking

This relates to Internal Audit contributing by discovering and telling the business something that they did not know and would not have found out without Internal Audit involvement. This could relate to feedback from the business, discussion papers or data analytical outputs and Internal Audit.

Red flagging

Assessing the current business and telling them in a timely manner something that they should be worried about and should act upon – this could be achieved through analysing emails/correspondence, assessing feedback from workshops or management and escalating appropriately. GDPR is one instance where red flagging could prove valuable.

Horizon scanning

Forward looking to predict future areas of risk, concern and non compliance – through thought leadership forums, audit reports or leveraging work from other lines of defence. This would relate to forms of emerging technology, such as AI and blockchain and the impact this could have on a company's risk profile.

Business focus

Aligning Internal Audit activities to the areas that are most important to the business – ensuring that Internal Audit is aligned to the principal risks and partnered with the business.

Business improvement

Agree actions that are practical and provide support to deliver business improvement – Internal Audit would contribute by protecting and improving business value; and qualify and quantify issues and outcomes, for example with gender pay gap reporting.

The importance of each Contribution Domain would vary by organisation. Audit committees should be using this framework as part of an ongoing dialogue with their Internal Audit function to help direct Internal Audit's focus and priorities.



Tax transparency and the rise of digital tax authorities

We are in a new era of tax transparency. It is an issue at the forefront of ethical, economic and political discussions, and companies are finding themselves in an increasingly challenging tax environment with pressure to explain their tax affairs. In addition to this, tax authorities are looking at new ways to access tax data electronically, which presents businesses with significant risks and challenges on delivering transactional data required reliably and on time.

Tax transparency

The level of business globalisation over the last few years and the resulting complex operating structures required to manage the organisational model and supply chain has meant that taxes have become an important part of the equation which can impact EPS and value. At the same time, tax itself is undergoing a huge international change as result of the OECD Base Erosion and Profit Shifting (BEPS) project and has become the focus of many stakeholders leading to increasing pressure for greater transparency of responsible tax management.

Expectations of the tax department are therefore increasing such that they are expected to contribute to broader business strategy as well as having to respond to greater transparency demands and reputational concerns. At the same time, tax authorities are becoming much more sophisticated as there is significantly more data at their fingertips and technology is increasing at a pace where they can use that data to assist the way they risk assess companies and conduct audits.

What is driving this change?

Tax audits reaching record numbers

Dramatic increase in audits and disputes triggered by OECD BEPS initiatives and CbCR.

Data sharing

Increase in data sharing between governments and between tax payer and tax authority including tax information sharing, FATCA, CRS.

Fair share

Increase revenue and decrease erosion of tax base.

Competing for revenue

Governments trying to attract investment through preferential tax regimes.

Reputation risk

Damage to brand due to being portrayed as a bad corporate tax citizen in the media – The tax morality debate.

Regulatory change

Senior manager regime, CRD IV, Basel II, Material outsourcing.

Transparency

Regulatory disclosure (e.g. FIN 48, UTP, country-by-country reporting, public disclosure of tax strategies.)

Emerging tax systems

Real time reporting and analysis by tax authorities, especially in emerging markets (e.g. Brazil).

Tax governance

Cooperative compliance drive across the OECD including SAO, tax strategy disclosure, Horizontal monitoring, risk based approach by tax authorities (inc. UK, Australia, Canada).

In April 2016, the European Commission put forward a proposal for public Country-by-Country Reporting (CbCR) disclosures. The proposal is still being discussed by the 28 EU member states in council and some states have limited appetite for adoption. It is unclear whether this will be treated as a tax issue (which requires unanimity) or an accounting issue (which requires a majority). The proposed content is broadly similar to that required by the OECD under BEPS.

Content of EU public CbCR proposals

Who is in scope?

Undertakings with a consolidated net turnover of EUR 750m or more.



Level of reporting for operations in Member States

Data to be reported on a geographical basis for each Member State (and certain jurisdictions which are regarded as having inadequate tax governance).



Level of reporting for operations outside the EU

Aggregated level data (apart from certain jurisdictions noted above).



Content of template

Brief description of activities; number of employees; net turnover; profit or loss before tax; tax accrued (excluding deferred tax and uncertain tax positions) in the year; tax paid in the year; accumulated earnings.



Commercially sensitive information

To ensure fair competition, commercially sensitive information may be temporarily omitted if it is seriously prejudicial to the commercial position of the company.



Availability

Publicly available on the company's website.



How are companies responding?

A small number of companies are providing voluntary public disclosures of CbCR data. However in isolation, data may be misunderstood and misinterpreted, leading to more confusion, undermining public trust. The OECD has voiced concerns that public CbCR could lead to confusion not clarity. Additional narrative can be critical to help explain and interpret the data and we have seen companies developing innovative disclosures which contain relevant and understandable data.

The rise in digital tax authorities

How tax authorities are accessing data

Tax authorities are now starting to access data in a completely different way. E-auditing is the method used by tax authorities to obtain and verify relevant taxpayer data electronically, and it has the highest hit rate of any of their powers. The success of these types of investigation, and the advancement and ease of adoption of relevant technologies, has led to a significant increase in data-led obligations being pushed onto taxpayers.

The Standard Audit File for Tax ('SAF-T') is a framework drafted by the OECD for tax authorities to use, to ensure taxpayers deliver data to them in a format they can easily audit. Although the framework is standard, no two SAF-T requirements are the same.

Critically, the scope of this and other similar obligations covers every transaction conducted, enabling forensic tax investigations to be carried out across any organisation.

E-auditing is hailed a success for each tax authority that's implemented it so far, driving up the taxable base and driving down taxpayer error. The information sent to the tax authorities allows them to:

- Profile taxpayers against expectations, analyse tax patterns, and plan for and target future tax audits.
- Conduct forensic audits, run tests to identify non-compliance and highlight areas to probe further.
- Compare, contrast and benchmark against other official data filed, and publically available big data, across the taxes.

This is a global initiative, with countries such as India, Brazil, China and Russia all using their own real time reporting methods to monitor transactions and tax collection.

How tax authorities are using data analytics

Tax authorities pull together data from a variety of sources to develop a more complete picture of companies' tax profiles. Companies are increasingly being asked to submit client invoices, statements of accounts, customs declarations, vendor invoices and bank records, all in formats specified by the government often in real or near-real time.

Why is this a risk for business?

Governments globally are increasingly leveraging technology to increase tax revenues and crack down on fraud. E-auditing and real time reporting approaches, such as SAF-T, are delivering the highest success rate for tax authorities in investigating compliance, increasing the tax base and reducing taxpayer errors. The increasing speed and ease of adoption of the techniques and technologies presents businesses with significant risks and challenges in delivering the transactional data required reliably and on time.

Why does it matter?

The volume and detail of information provided enables tax authorities to:

- Profile taxpayers against expectations, analyse tax patterns and plan for and target future tax audits to maximise returns.
- Conduct forensic audits, run tests to identify non-compliance and highlight areas to probe further.
- Compare, contrast and benchmark against other official data filed or publicly available big data, across taxes, across taxpayers and with tax authorities in other countries.
- Organisations need to develop a proactive, scalable and sustainable strategy to address this if they are to minimise the risk and cost of non-compliance and, importantly, the costs of responding to each new requirement on an individual, 'point solution' basis.

How are companies responding to controlling data in order to minimise risk?

All organisations need to consider:

How to respond to the data challenge today – specifically the current compliance obligations and how to manage an ever increasing speed of adoption. For example, Lithuania put in SAF-T in just two months.

How to deal with the increased real time obligations and scrutiny of the future—many organisations are looking to develop a pro-active and scalable strategy to address the issue. This will need to encompass actively improving the quality of tax data, ensuring processes are productive, using technology effectively and mitigating the exposure to penalties and reputational risk.

Tax no longer should be spending time manually manipulating and analysis historic data in complex unstable and restrictive spreadsheet models. Tax needs tax ready data that supports visualisation and predictive analytics to support forward looking analysis and to understand what their future data may be telling tax authorities.

Tax analytics can empower a tax function to:

- View multiple periods and scenarios of data at the touch of a button.
- Visualise global changes to structure or filings.
- Track customised KPIs e.g. effective tax rate (ETR), cash tax etc.
- Review ‘what if’ scenarios for legislative or business changes.
- Automate decision making for areas such as fixed assets.
- Predict rate drivers affecting the ETR.

What it means for companies and audit committees

Tax authorities’ enhanced use of data analytics means that companies – and their tax and finance departments – need a shift in mindset around how they collect, store and analyse tax and financial data. Documents may be stored in various places, such as network shared drives, personal hard drives, external providers’ systems, document management systems and emails.

Adding to the challenge, the requested information may be spread across different functions and geographic locations. This can make it hard to find data when it’s needed and know when that data has been collected or delivered. These challenges can be mitigated through development of a robust data management and analytics system.

The volume of requests and short response time for compliance means that companies need sophisticated data management and analytic capabilities that meet or exceed those used by tax authorities. They also need people familiar with these enhanced data requirements to develop and maintain those systems.

Furthermore, they must take proactive steps to create files that are ‘audit ready’ when submitting requested information to the relevant tax authority – particularly in this environment of increased transparency and information exchange.



Contacts

If you want to know more about any of the issues discussed above, then please contact one of our subject matter experts.

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Tax transparency and the rise of digital tax authorities

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