Audit Trends

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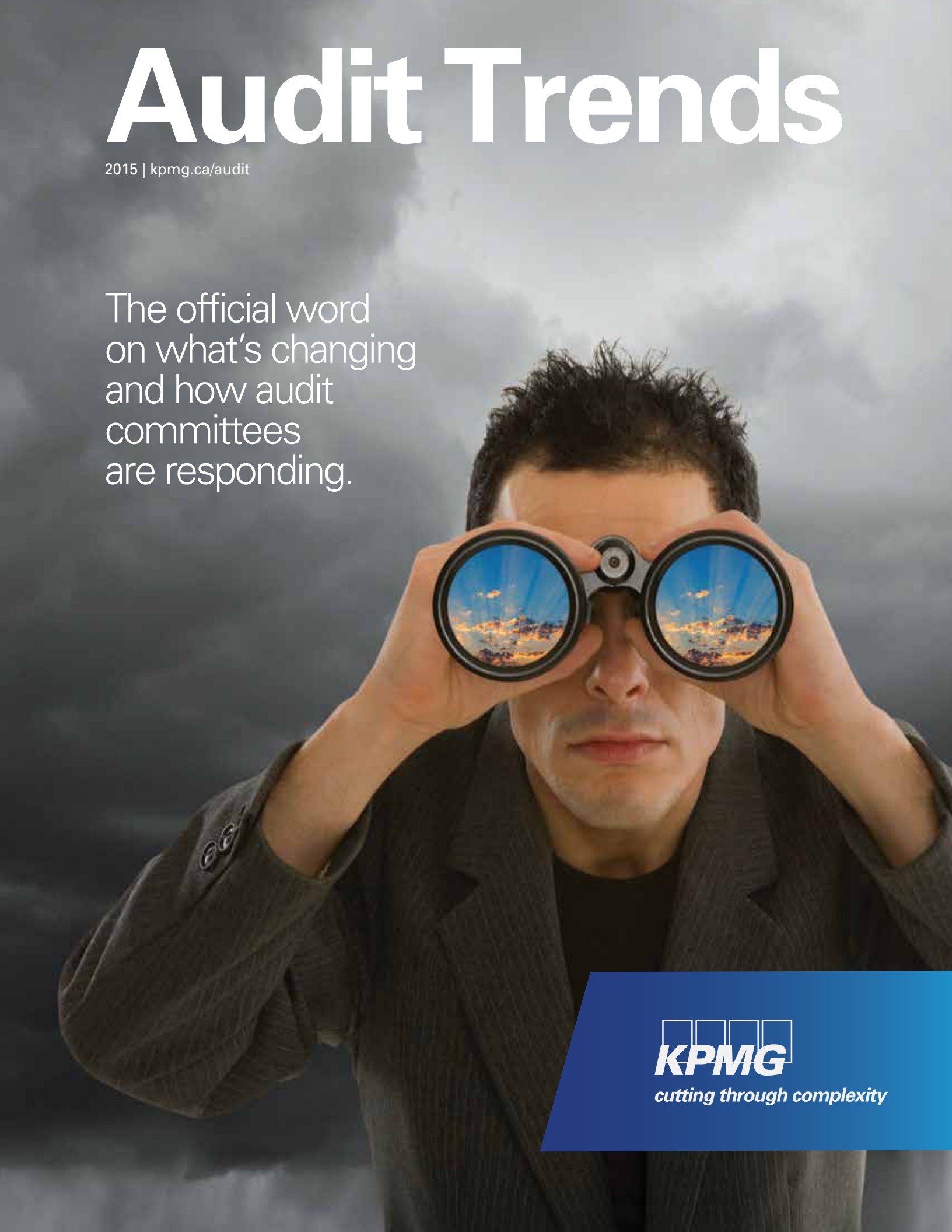
The official word on what's changing and how audit committees are responding.



KPMG

cutting through complexity

Virtually everyone understands that the role of the audit committee is changing.

Into what?

What factors are driving change?

And how should ACs respond?

With so many considerations at play, these are difficult questions to answer. Yet, it's incumbent upon stakeholders – AC members, their companies, auditors and regulators – to pursue the answers and expand current thinking to match the rapidly shifting audit and oversight environments.

ACs TODAY DEAL WITH A BROAD RANGE OF ISSUES, AND ACCOMPANYING RISKS, THAT ARE BEYOND FINANCIAL STATEMENTS, REPORTING AND INTERNAL CONTROLS OVER FINANCIAL REPORTING – THEIR TRADITIONAL AREAS OF RESPONSIBILITY.

These include CFO succession management; forecasting & planning; liquidity; M&A; environmental, social and governance factors; fraud and more. In many ways, ACs have had to assume the role of risk committee. It makes a certain degree of sense, since ACs have a fundamental risk focus, for other risk responsibilities to be on their agenda. In fact, in Canada and some other countries, "risk" has even been incorporated into the committee's name. However, this expanded risk mandate is changing the fundamental activities ACs pursue, adding significantly to their time commitments and workloads, and necessitating a much broader understanding of the global economic environment in which they operate.

THE DAYS WHEN THE AC AGENDA WAS SOLELY DOMINATED BY AUDIT MATTERS AND TECHNICAL ACCOUNTING DISCUSSIONS ARE GONE.

Many ACs are diversifying. They're bringing in specialists in areas only peripherally connected to finance, such as social media and cyber security – or in specific risks associated with their industry – so they can handle new challenges while still focusing on financials, reporting and controls. In some cases they are splitting as boards recognize that oversight from a single AC may be insufficient to handle growing mandates. To meet the demands placed on them, they're also looking for more from auditors than an opinion on financial statements.

During in camera sessions, they are having more in-depth conversations with their auditors. At the same time, they are seeking information that's reported in a more concise, digestible and issue-specific format. What form this will eventually take and what content will ultimately meet ACs' value-add wish list remains an evolving area, one that's continually mediated by businesses, regulators, auditors and shareholders. ACs clearly want crisper reports with more informal/personal insight beyond the financial statements, but significant questions remain: How much can auditors actually provide? How much should they provide? How much will regulators allow?

As these questions are debated and resolved, the audit profession will change along with the AC. During this transition, all stakeholders need to define the key issues shaping both the evolving risk mandate and the expanding AC agenda. With this in mind, KPMG teams across our Canadian and the Global audit practices identified five key areas to which AC members should pay particular attention. By identifying and tracking developments in these areas, ACs can gain a deeper understanding of both their new risk responsibilities and their traditional duties for overseeing the audit and reporting processes.

These areas are subdivided into the external issues that may affect the AC's risk oversight responsibilities and the internal processes that are either changing in response or that may need to be implemented going forward.

Contents

Dealing with the pressure – external issues

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IT risk

CYBER SECURITY

Cyber security has become an enormous issue in the last few years and its importance continues to grow. Major corporations' networks and systems continue to be subject to hacking and attack. This is especially true in some emerging markets. In recognition of this, some companies will not permit employees to take their laptops into certain countries, but rather will issue "clean" laptops that have no company - or client-related data on them. Cyber criminals, such as those that recently impacted Target, Sony and Saudi Aramco, also continue to increase their level of activity, making cyber security in general a major risk to both revenue and reputation.

SOCIAL MEDIA

There are also a number of risks associated with cyber security that can originate within the company but have a major external impact, such as when unauthorized information leaves the company.

In the new cyber reality, where a mobile labour force regularly moves and shares critical data across the corporate firewall, data integrity and fraud become issues, and ACs in Canada and elsewhere are showing an increased interest in IT-related risks and impacts, such as those associated with social media.

Many companies are now paying closer attention to issues around social media in an effort to prevent information being leaked without preapproval through Facebook or Twitter. These committees are, for example, looking to limit what CEOs and CFOs can say regarding corporate metrics if the comments have not been vetted by the committee. There are also risks, even harder to control, from public social media communities.

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"Organizations today rely heavily on technology to manage internal processes and external customer relationships, it is therefore essential for ACs to understand what management is doing to mitigate IT risks."

– Carlo De Mello
Partner and Business Unit Leader Vancouver, Audit

ACs should certainly be on the alert when it comes to IT risk management. Taking a proactive, strategic approach – rather than a reactive, risk-mitigation one – is important. Does your company have a strategy for managing cyber crime and social media risk? If you have a broad corporate risk framework in place, are cyber security and social media part of it? Are directors themselves using secure IT technology when it comes to their devices and board-specific software? These are critical questions for ACs to ask and answer, and they should consider sharing best practices with colleagues on other boards.

Regulatory change and management

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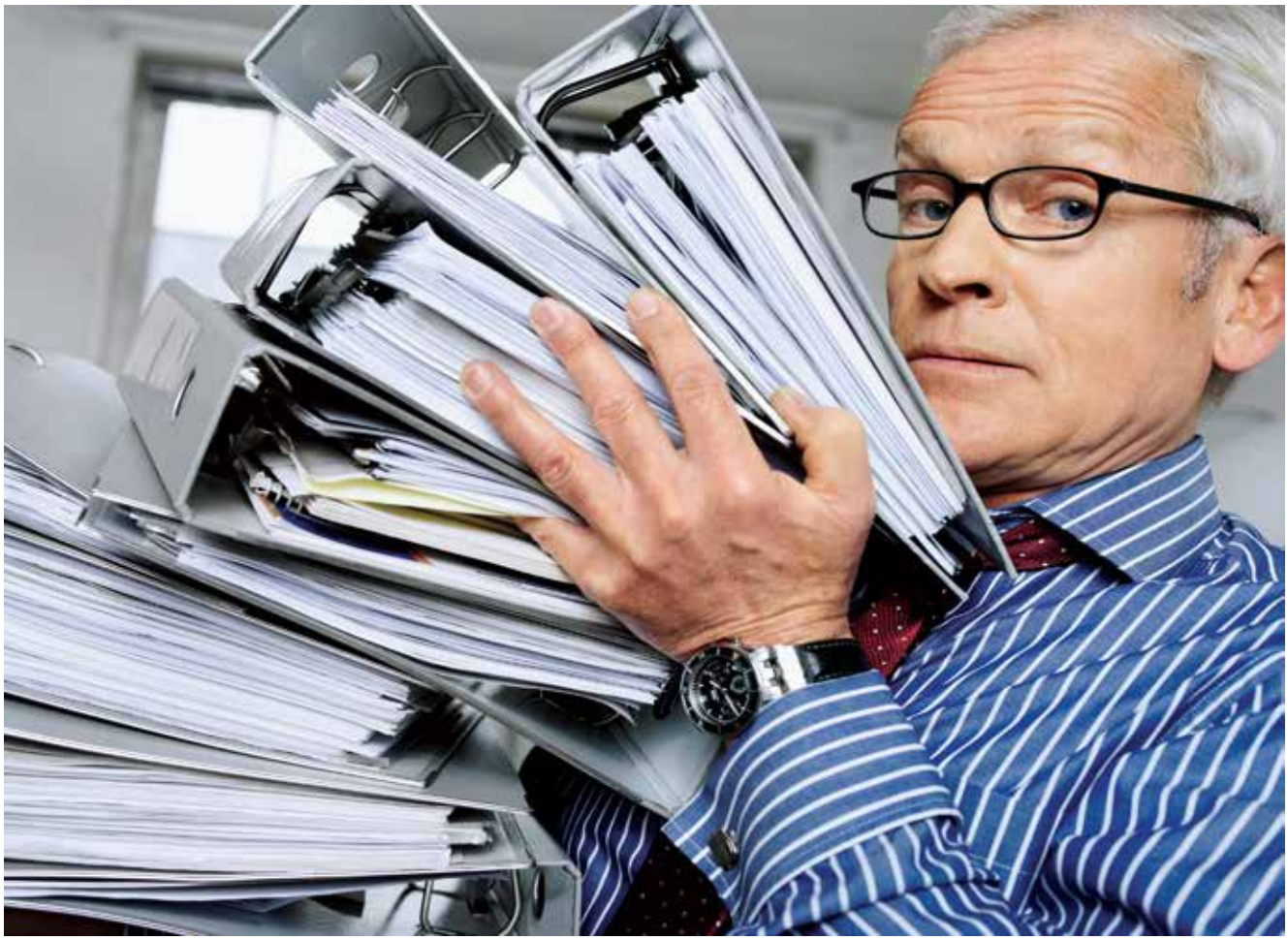
THE IMPACT OF REGULATORY CHANGE FOLLOWING THE IMPLEMENTATION OF THE *SARBANES-OXLEY ACT* IN THE EARLY 2000s CANNOT BE OVERSTATED.

Every industry has been affected by the focus companies put on the regulatory environment and compliance risk – not just around the audit, but in a growing number of other areas – has become the purview of the AC. As a result, AC members in highly-regulated sectors, such as financial services find themselves putting a lot more time and energy into interacting one-on-one with regulators.



If there aren't regulations affecting specific industries, simply operating on a global scale raises a broad range of compliance issues, particularly when dealing with countries such as Brazil, China, Nigeria, Russia and a number of others. Consider the ongoing issue between the Big Four audit firms, the SEC, the PCAOB and the Ministry of Finance of the People's Republic of China, where the SEC wants access to the working papers of Chinese member firms in order to enforce an action – access those member firms believe they cannot provide as it would violate Chinese law.

The global regulatory environment is highly dynamic, adding complexity and risk to the AC's mandate. Rather than filling in a checklist saying you've done what's required, ACs would benefit from turning governance guidelines and regulatory requirements into best practices that are integrated and embedded throughout the organization to deliver ongoing value and reduced risk to the company. Of course, given the number and complexity of regulations ACs deal with, that's easier said than consistently done.

THERE IS A LITANY OF REGULATORY CHANGES AND INITIATIVES THAT A QUICK REVIEW CAN ONLY TOUCH ON.

- The OSFI (Office of the Superintendent of Financial Institutions) recently issued a corporate governance guideline setting out specific oversight and governance expectations around AC activities.
- Canadian Securities Administrators (CSA) have recently become very focused on additional performance measures and non-GAAP measures in financial statements, asking companies to explain why they use certain measures in financial statements and others outside them.
- The *Dodd-Frank Act* contains more than 90 provisions that have required the SEC to enact new rules – which continue to be implemented – designed to increase transparency for investors.
- Non-profit organizations (NPOs) should consider the Canada Revenue Agency's (CRA) report on NPOs – *Non-Profit Organization Risk Identification Project* – released in February, which highlights specific high-risk activities.
- EU audit reforms (such as mandatory firm rotation) will have a global impact on every public interest entity (PIE) in the EU and potentially on foreign companies with subsidiaries in the EU that meet the definition of a PIE. Mandatory firm rotation in India may also effect Indian subsidiaries of Canadian companies.
- The 2013 COSO framework requires entities to update their internal control framework and may require companies to revisit the design and implementation of their existing internal controls.
- As one of the strictest regulations of its kind in the world, Canada's *Corruption of Foreign Public Officials Act (CFPOA)* requires additional attention from management in ensuring its requirements are met. For their parts, the *US Foreign Corrupt Practices Act (FCPA)* is being stringently enforced, as is the *UK Bribery Act* (each country has an equivalent, but these are the most internationally potent).
- Even export controls and sanctions are being enforced more stringently and are extending to a wider range of countries and sectors.

3 Globalization issues

ON TOP OF THE CHALLENGES IMPOSED BY THE REGULATORY ENVIRONMENT, SEVERAL OTHER ISSUES RELATED TO GLOBALIZATION ARE, OR SHOULD BE, SHOWING UP ON THE AC AGENDA.

Global transfer pricing becomes a more serious and contentious risk area with each passing year and without a doubt the number one international tax issue for most multinationals. With certain countries – including Ireland, Luxembourg, Singapore, Switzerland and others – having lower tax rates as well as other tax incentives, companies are incented to drive tax efficiencies (often in addition to operational efficiencies) by centralizing or regionalizing operations to these jurisdictions. This creates significant complexity and risks for Canadian companies since, of all the national tax agencies, the CRA and Canada Border Services Agency (CBSA) are the most active and aggressive in opposing certain artificial transfer pricing strategies.

By generating large profits overseas, global transfer pricing strategies (whether aggressive or not) create enormous political pressure and, in turn, politicians are pointing fingers at companies that engage in it. In Canada, for instance, multinationals with a significant international footprint and globalized operating models using tax favourable jurisdictions are often perceived as aggressively generating large offshore low-taxed profits. This behaviour, as such, creates public and political pressure as tax minimization strategies foster the perception of Canadian multinationals not paying their fair share of taxes – including duty, excise and VAT – and being put at a significant advantage over purely domestic Canadian companies.

ACs should understand the asset/liability management processes employed by management to mitigate the risk of changes in interest rates. In addition, ACs should understand what assets and liabilities are especially sensitive to interest changes, such as long-term pension obligations and valuations of long-lived assets.

The interest rate environment – post-crisis, we've had a prolonged period of extremely and perhaps artificially low interest rates. This has been part of a concerted strategy by major central banks, especially the U.S. Federal Reserve. The Fed has been following a policy of large scale purchases of government securities since 2008 – a policy which serves to increase banks' available funds and maintain low interest rates. However, recently the Fed has begun tapering these purchases, which may be setting the stage for a very deliberate shift in monetary policy. Of course, we know interest rates will rise in the future, but not when. That uncertainty has global implications. **While the Fed is responsible for managing inflation and employment in the U.S., its interest rate decisions affect everybody. In fact, the Reserve Bank of India has criticized the Fed for the extra-territorial impact of its policies.**

EMERGING MARKET TURMOIL

While turmoil surrounding emerging markets is never new, the countries currently posing the greatest risks shift continually and rapidly. For example, the social unrest currently afflicting Venezuela has had a major impact, with several multinationals taking charges in the hundreds of millions in the first quarter of 2014. While Venezuela may represent only a small portion of a corporation's revenue, such charges have a disproportionately large effect, especially if the currency is further devalued.

Other countries, such as Russia and the Ukraine, have issues that are driving political sanctions that prohibit Canadian companies from doing business with certain entities, while Argentina is beset by inflation and political instability, and ACs should also focus on the risks arising from doing business in those countries. **Moreover, it's important they understand related risks to the company and its mitigation strategies and that they focus on the impact of "what if" scenarios as well as financial reporting and internal control components.**

Looking within – evolving measures and processes

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Annual External Reporting Suite

COMPANIES ARE FACING NEW CHALLENGES WHEN NAVIGATING THE VARIOUS FORMS OF EXTERNAL CORPORATE REPORTING.

As investors and other key stakeholders continue looking more broadly than the financial statements to inform their opinions and analysis of a company's performance, management is left to navigate the preparation of a variety of mandatory and voluntary public disclosure documents.

The *Annual External Reporting Suite* includes reporting related to financial, operating, environmental, social and governance performance often contained in annual reports, MD&A (management discussion & analysis), proxy statements, corporate responsibility reports and investor presentations.

Each of these disclosures present an opportunity to tell an important piece of the company's story and together should result in a series of high-impact, focused reports with a common thread of key messages to the public regarding the company's unique achievements, challenges and strategy.

Additional consistency in the application of oversight and controls across these various reports is crucial to developing streamlined, focused and effective reporting.

Yet, all too often, a near-final draft of an external report is circulated without adequate time for executive and board member input and review. For example, the audit committee sometimes does not receive the MD&A in timely fashion, leaving them no opportunity to reflect on specific areas of emphasis, provide input to management or have their commentary included. Similar challenges arise with investor presentations. Securities commissions are increasingly paying closer attention to disclosures within these presentations and requesting corrections where the information disclosed differs from information shared in the MD&A.

Securities commissions are increasingly paying closer attention to disclosures within these presentations and requesting corrections where the information disclosed differs from information shared in the MD&A.

"Historically, company disclosures were predominantly confined to financial statements, but that's no longer true. As such, ACs should ensure that consistent messaging appears across all corporate disclosures – from annual reports and proxy statements to corporate responsibility reports and investor presentations."

– Bill Murphy
National Leader, Climate Change and Sustainability

IN THE CASE OF THE CORPORATE RESPONSIBILITY REPORT, THE REPORTING PROCESS – FROM DATA COLLECTION TO WRITING AND REVIEW – IS OFTEN NOT SUBJECT TO A SIMILAR LEVEL OF CONTROL AS FINANCIAL REPORTING.

As a result, it is not uncommon to spot inconsistencies and see frequent restatements of data in these reports. According to a recent KPMG survey, 25% of the world's largest companies made corporate responsibility data restatements in 2013, up from 21% in 2011[1]. While most restatements were due to the use of improved estimation/calculation methodologies or the application of updated definitions, many were still the result of errors and omissions.

Similarly, recent tax transparency issues – with respect to transfer pricing, for instance–highlight how serious reputational issues can develop when there is media attention, public scrutiny and lack of transparency regarding a company's tax strategy. Companies are now addressing this important topic within the corporate responsibility report, or in standalone tax transparency reports, the most recent report to join the *Annual External Reporting Suite*.

As a best practice, companies should ensure a coordinated approach across the various forms of reporting by adopting a comprehensive disclosure plan to support the development of all external annual reports. This approach will ensure consistency of message and accuracy of information, and enhance the overall quality and effectiveness of reporting.

Transforming the audit

As Data & Analytics tools become mainstays of modern business, the use of analytics-based audits is rising. Unlike traditional audits, which rely on relatively small data sets to extrapolate conclusions across the full financial data, analytics-based audits have the capacity to incorporate the totality of an organization's financial information.

By analyzing millions of transactions, auditors can identify irregularities and key risk areas at a much more granular level. Additionally, analytics audits is able to take external data into account to analyze and predict how weather, economic, industry and other factors might affect performance. As this audit database expands over time, auditors will gain an enhanced understanding of a company's financial character and risk profile, to improve audit insight and quality each year. There will also be a greater ability to benchmark an individual company's performance against broad industry or geographical data sets, allowing auditors to share a far more valuable body of information with key stakeholders.

As this process evolves, ACs can stay on top of developments by asking their auditors how they plan to use Data & Analytics in the audit, how substantive procedures may evolve through this automated approach and where their capabilities will be in three to five years.

[1] The KPMG Survey of Corporate Responsibility Reporting 2013

5 Internal evaluation and controls

ONE OF THE AC's CORE OVERSIGHT DUTIES IS TO ENSURE MANAGEMENT'S INTERNAL CONTROLS OVER FINANCIAL REPORTING PROVIDE ACCURATE AND RELIABLE INFORMATION.

One trend has ACs benchmarking various groups within the company against their industry peers to see, for example, if the internal audit function is effectively designed – if it delivers the right information to the AC in a timely manner, looks at the right risks and adds value to the company.

In another trend, AC chairs–faced with synthesizing such an enormous amount of supplemental material–are reaching out to external auditors more frequently than in the past. They're more interested in getting the unbiased insights of their external auditor on issues, such as the effectiveness of management's financial reporting team, what trends they see in other companies, the adequacy of the materials they receive, etc. They're also looking for advisers to identify ways both they and management can improve, based on peer group observations.

Taking this self-reflexive analysis a step further, some organizations, seeking a view that's fully independent of management, are undertaking third-party governance reviews of internal controls within the risk, compliance, finance and internal audit functions. Currently, this review process is more common in the financial services sector as a result of the recent OSFI corporate governance guidelines, but it may soon become a general governance best practice. Practical experience with these types of reviews suggests that they are complimentary to the financial statement audit and help further support ACs in discharging their mandates.

ACs rely on these control functions to effectively execute their oversight responsibilities and third-party reviews can significantly support and justify that reliance.

Going forward, ACs should consider implementing these kinds of initiatives, if they have not already, to enhance effectiveness, value and risk management, and to stay ahead of the game should such initiatives become accepted corporate governance best practices.

"To enhance their oversight role, some ACs are seeking third-party reviews of the effectiveness of management's internal controls, not only as they relate to financial reporting but also as they relate to risk, compliance and internal audit. For many organizations, this is a trend worth considering."

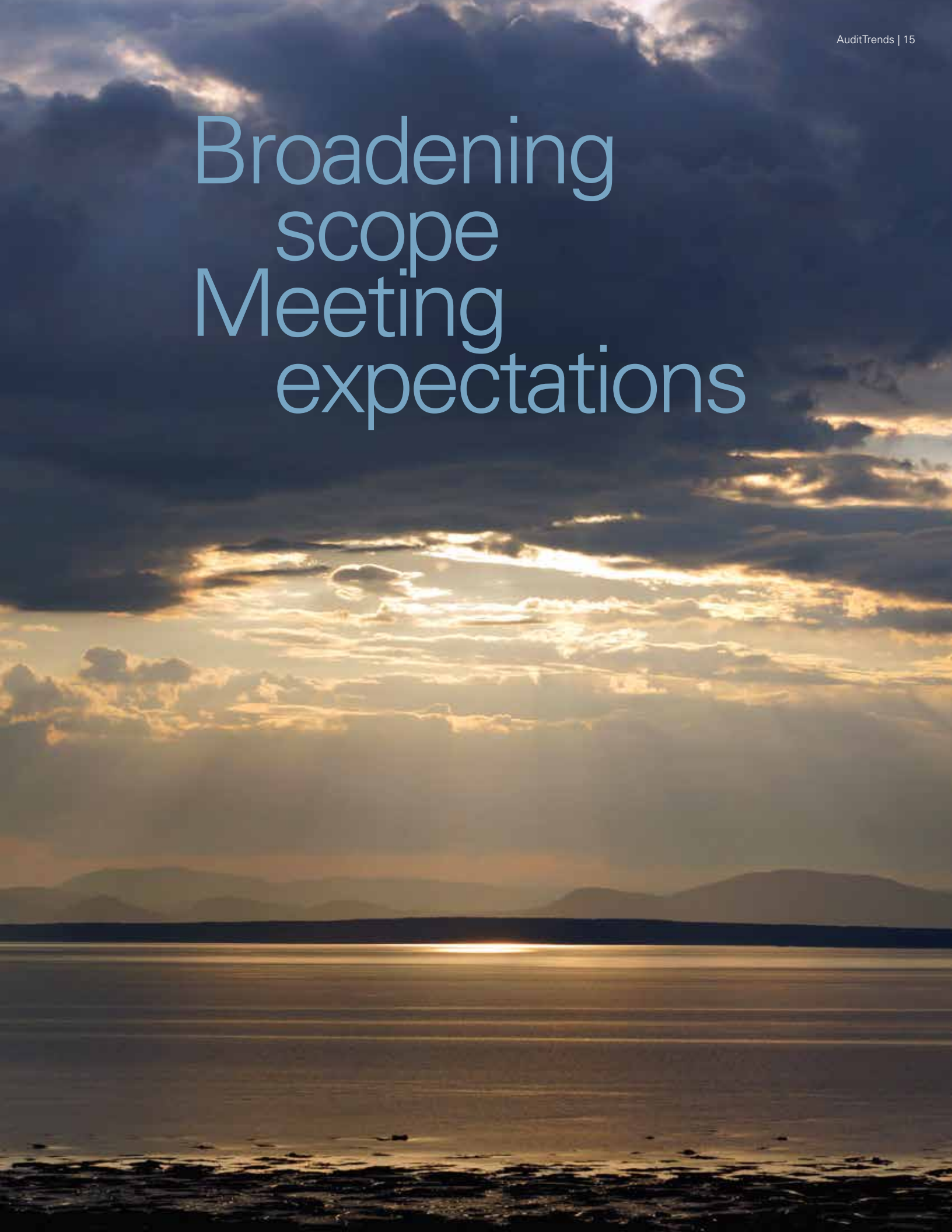
– John Gordon
Canadian Managing Partner, Audit

AC checklist

THINGS TO THINK ABOUT THROUGHOUT THE YEAR

- [ ] Focus on non-GAAP measures prior to any quarterly, annual or interim reports.
- [ ] Consider investing in new – or retraining existing – people and processes to manage the growing regulatory burden.
- [ ] Self-assess board capabilities and make changes where necessary to strengthen diversity, risk experience and financial expertise.
- [ ] Look to develop a more prospective or strategic focus as opposed to a reactive one.
- [ ] Make sure you are comfortable in your knowledge of increased expectations and risk responsibilities and satisfy yourself that management's response to those risks is appropriate.
- [ ] Engage with your audit firm and with other ACs to fully understand and proactively influence what's happening in the audit landscape.
- [ ] Address social media, cyber security and IT issues to ensure reputational and business continuity risks are priorities.
- [ ] Communicate with investors, analysts and stakeholders (consider meeting with them directly if requested); you can create stability by ensuring that, along with receiving quality financial information, they fully understand organizational goals and strategy.
- [ ] Conduct an auditor evaluation; if it results in a reappointment recommendation, make sure that recommendation is done before the proxy circular is sent out.

Broadening scope Meeting expectations



The mandate question

In this report, we've laid the groundwork for filtering your upcoming audit through a number of new, increasingly influential perspectives.

We look forward to reviewing them with you to see which topics rise most strongly to the fore, which stand to affect the audit process and which most influence your reporting process and shareholder response.

ACs FACE AN EVER-BROADENING MANDATE TO OVERSEE A GROWING RANGE OF ACTIVITIES, CONTROLS AND DISCLOSURES.

The question of how far they will formally extend their risk role is still open to question. Will ACs play a greater role in overseeing overall risk management programs as well as dealing with additional risks beyond those attached to financial reporting? Will we see the combined "audit and risk committee" become the norm? Will they be able to find the right balance between information and execution to balance both mandates?

As ACs consider these questions, they look to auditors to support their ongoing transformation by improving audit value. With global developments in audit quality and independence in the wind – such as audit firm rotation, audit partner rotation and external audit reviews – ACs are broadening and enhancing their relationship with the auditor while also seeing the audit as a service area from which they want to extract more value.

That's part of why we developed this report – to foster dialogue on how auditors can add more relevance to the audit and potentially provide assurance on items beyond the financial statements. The focus on audit file compliance – while a natural result of the current, aggressive regulatory climate – is simply not enough.

ACs are striving to define their changing role and execute effectively on their evolving responsibilities. Regardless of how the AC agenda evolves, ACs must make sure they have the time and capabilities to handle these shifting roles while maintaining a strong focus on financial reporting and information reliability.

This cannot, however, be done without understanding and charting the rapidly changing audit environment – and what better way than to specifically examine the most critical issues in both a pre-and post-audit context?

Shaping the future of audit in Canada

To help you strengthen corporate governance, enhance audit committee oversight and add greater value within your organization, visit **www.kpmg.ca/audit**

AUDIT POINT OF VIEW

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