KPMG
cutting through complexity

AUDIT COMMITTEE

TOP PRIORITIES FOR 2014

In 2014, the audit committee agendas of Hong Kong based companies will be shaped by continued economic uncertainty, globalisation and geopolitical turbulence, increased government regulation and an interconnected world where technology is accelerating everything. In response to these factors, we are seeing more and more boards adopt a structured approach to risk management. Exercising judgement about what does and does not belong on the committee's agenda, and taking deep dives on key risks and challenges facing the business will be critical. To help audit committees meet the governance challenges of the coming year we offer KPMG's Audit Committee Priorities for 2014.

Stay focused on job #1: Financial accounting and reporting

Challenging global economic conditions and concerns about China's economic growth, together with major public policy initiatives—tax reform, financial services regulation, new accounting standards, and a challenging regulatory environment—will require the attention of every audit committee. Continue to monitor fair value estimates, impairments, and management's judgments of key assumptions underlying critical accounting estimates, and understand management's framework for making accounting judgments and estimates. Stay apprised of key IASB projects (revenue recognition, leases, financial instruments, and insurance contracts) which have significant implications not only for the company's financial reporting and accounting, but also staffing and resources, processes, and—perhaps most significantly—IT systems.

Financial reporting quality starts with the CFO and finance organisation, so maintain a sharp focus on leadership and talent, make sure they have the resources to succeed, and encourage them to stay focused on the company's long-term performance. Is there a formal CFO succession plan in place—and a process for the audit committee to gain visibility into the finance organisation's bench strength, one and two levels below the CFO?

Monitor key regulatory changes and proposals that may impact the external auditor's role

Regulators globally are advancing an array of initiatives focused on enhancing auditor independence, objectivity, and professional skepticism as part of an ongoing effort to improve audit quality and transparency. These initiatives—ranging from newly enacted audit firm rotation requirements in Argentina and The Netherlands, and proposals on mandatory rotation and restrictions on non-audit services in the European Union, to PCAOB projects on audit quality indicators and proposed changes to the auditor's reporting model—may have a significant impact on the audit process across jurisdictions. In Hong Kong, there are moves to establish an independent auditing regulation body with powers of enforcement and disciplinary action. Stay apprised of these initiatives and their implications and take the lead on ensuring audit quality—weighing key indicators, such as the knowledge and experience of the engagement team and the audit firm's internal quality reviews. Also, consider expanding the audit committee's report to provide investors with more insight into how the committee carries out its oversight responsibilities (see "Enhancing the Audit Committee Report" at www.thecaq.org and "The Financial Lab Project Report: Audit Committee Reporting" at www.frc.org.uk).

Leverage internal audit as a barometer of the company's financial health

Consider the need to refine internal audit's role, potentially sharpening internal audit's focus on key areas of risk and the adequacy of the company's risk management processes generally. Internal audit is most effective when it is focused on the critical risks to the business, including key operational and technology risks, and related controls—not just compliance and financial reporting risks. What's changed in the operating environment? What are the risks posed by the extended global organization—sourcing, outsourcing, sales and distribution channels? Be sure that internal audit focuses on the adequacy of management review controls (i.e., the precision of those controls and documentation that demonstrates that precision). Set clear expectations and assess whether internal audit has the resources, skills, and expertise to succeed in the role that management and the board envision.

Internal audit should have the potential to move to a higher value-add model, functioning as an increasingly valuable resource—a trusted adviser and consultant—to the audit committee with the right focus, resources, and independent perspective.

MATTERS FOR THE AUDIT COMMITTEE

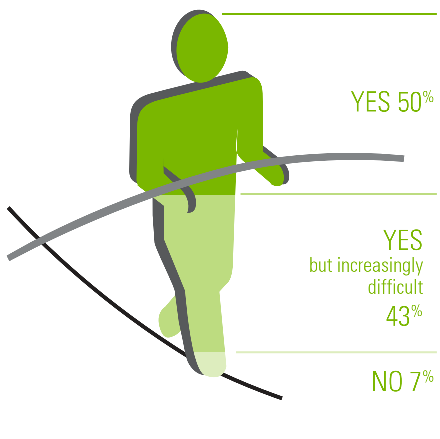
1. Stay focused on job #1: Financial accounting & reporting
2. Monitor key regulatory changes and proposals that may impact the external auditor's role.
3. Leverage internal audit as a barometer of the company's financial health
4. Make sure the company's ethics and compliance programs are keeping up with new vulnerabilities to fraud and misconduct
5. Understand the company's significant tax risks and tax risk appetite

BOARD MATTERS INFLUENCED BY THE AUDIT COMMITTEE

6. Recognize that good risk management entails both defence and offense
7. Assess the adequacy of the board's oversight of Information Governance
8. Set the tone and closely monitor leadership's commitment to that tone

Make sure the company's ethics and compliance programs are keeping up with new vulnerabilities to fraud and misconduct
Whether moving quickly to capitalize on growth opportunities in new markets, leveraging new technologies and data, or engaging with more vendors and third parties across longer and increasingly complex supply chains, companies face heightened risk of fraud and corruption. These vulnerabilities, coupled with the complex global regulatory environment—including FCPA and the UK Bribery Act, the SEC's whistleblower program, and the sheer volume and scope of new regulations—will require continued attention. Ensure that the company's regulatory compliance and monitoring programs cover all vendors in the global supply chain and clearly communicate the company's expectations for high standards of ethics and social responsibility. More broadly, recognize that the "radical transparency" enabled by Twitter, YouTube, Facebook, and other social media has effectively put every company in a fishbowl: the company's culture and values, its commitment to integrity and legal compliance, and ultimately, its brand reputation are on display as never before.

Are you satisfied that your committee has the time and expertise to oversee the major risks on its agenda in addition to carrying out its core oversight responsibilities?



Source: KPMG's 2014 Global Audit Committee Survey

Understand the company's significant tax risks and tax risk appetite
The days are gone when tax was solely an expense to be managed. Companies today must deal with fundamental changes in attitudes and approaches to tax globally, with notions of "fairness" and "morality" influencing the debate. Understand the company's international tax risks and the reputational implications—particularly in light of international efforts to address perceived base erosion and profit shifting techniques. Be prepared for individual countries to implement formal "tax transparency" requirements, including quantifying the "total tax contribution" made to the reporting jurisdiction. Ensure that tax decisions take into account potential reputational risks and not simply whether the company has technically complied with the tax laws in various jurisdictions. Also, ensure that the tax function is monitoring tax reform debates in all relevant jurisdictions and analyzing the impact of possible legislative change.

Given the importance and sensitivity of tax risk today, help determine and articulate the company's tax risk appetite. Establish a clear communications protocol for the chief tax officer to update the audit committee regularly. Ensure the adequacy of the company's tax resources and expertise globally.

Recognise that good risk management entails both defence and offense
For years—particularly in the aftermath of the financial crisis—risk management has been viewed largely through a "defensive" lens: identifying and assessing, managing and mitigating, and communicating about risk. While a solid defence is essential, more companies today also see good risk management supporting their offense—as a strategic capability helping people throughout the organization make smart risk-adjusted decisions, shaping strategy, and adding competitive value.

Here are four key areas for the board to probe: First, do we have a clear risk philosophy and appetite—e.g., What risks are acceptable and how do they align with strategy? How much financial risk is the company willing to take? What risks are we unwilling to take, no matter how low the probability? Second, do we have a true understanding of our risks, reflecting the realities of the business and operating environment—and always adapting to changes in the environment, whether it's a new technology or macroeconomic conditions? Do we have robust risk discussions—and are we conscious of our biases? Third, have we clearly allocated management's risk responsibilities and decision rights? And finally, observe how decisions are being made and evaluate the thought process, with the goal of continually refining the decision-making process so the company is intelligently taking profitable risks.

Also, consider whether the board's current allocation of risk oversight responsibilities—particularly those assigned to the audit committee (such as compliance, financial, technology, and cyber risk)—is appropriate.

Assess the adequacy of the board's oversight of Information Governance
The convergence of social media, the cloud, mobile devices, and big data—what Gartner calls "The Nexus of Forces"—is fundamentally changing the competitive landscape and creating both new business opportunities and business risks. Increasingly, companies are relying on third party providers for technology solutions. Cyber attacks have been ranked by the World Economic Forum as a 'Top 5 Global Risk' for 2014 by likelihood. The pace of change is accelerating. Do we understand the transformational implications of these technologies for the company's strategy and business model? Do we have the right leadership and talent to make the most of these technologies? Do we know where our next competitors will come from?

The key challenge for boards today is to help shape the company's strategy and manage the related risks in a business environment undergoing massive change. That requires more than oversight. Does the board have insight and foresight about these technologies and their impact on the business, the industry, and the competitive environment? Are discussions within the traditional boardroom structure sufficient?

In addition to "financial expertise," what other in-depth experience or expertise currently resides on your audit committee? (select all that apply)

Source: KPMG's 2014 Global Audit Committee Survey

Set the tone and closely monitor leadership's commitment to that tone
With the business environment changing so rapidly and profoundly, and the pressures on management intense, be acutely sensitive to the tone from (and example set by) leadership. Reinforce the right culture—i.e., what the company does, how it does it, and the culture of compliance, including a commitment to financial reporting integrity throughout the organization. Is the board hearing views from those below senior management and outside the corporate office and beyond? Are there dissenting voices? Recognize when asymmetric information risk—the reliance on senior management's information and perspective—is too high. Make time to visit company facilities and attend employee functions. Does the board have a good sense of the tone and culture in the company's global operations and extended organization, far away from headquarters? Is management actively "listening to the conversation" on social media to better understand the risks, opportunities, and changing attitudes and perceptions about the company?

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