KPMG
cutting through complexity

Audit committee trends

What's changing and how audit committees are responding

It's increasingly obvious that the role of the audit committee is changing.

Into what?
What factors are driving change?
And how should audit committees respond?

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

Audit committees today deal with a broad range of issues, and accompanying risks, that go 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, audit committees have had to assume the role of risk committee. It makes a certain degree of sense, since audit committees have a fundamental risk focus, for other risk responsibilities to be on their agenda. In fact, in the UK and some other countries, "risk" has even been incorporated into the committee's name. However, this expanded risk mandate is changing the fundamental activities many audit committees pursue, potentially adding to their time commitment and workload, and necessitating a much broader understanding of the global economic environment in which they operate.

The days when the audit committee agenda was solely dominated by audit matters and technical accounting discussions are gone.

Many audit committees are diversifying. They're bringing in specialists in areas only peripherally connected to finance, such as social media and cyber security – or in specific risk areas 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 recognise that oversight from a single audit committee 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 private 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 audit committees' value-add wish list remains an evolving area, one that's continually mediated by businesses, regulators, auditors and shareholders. audit committees 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 audit committee. During this transition, all stakeholders need to define the key issues shaping both the evolving risk mandate and the expanding audit committee agenda. With this in mind, we have identified five key areas to which audit committee members should pay particular attention. By identifying and tracking developments in these areas, audit committees 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 audit committee's risk oversight responsibilities and the internal processes that are either changing in response or that may need to be implemented going forward.

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Dealing with the pressure – external issues

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IT risk

CYBER SECURITY

KPMG's analysis of the FTSE350 Cyber Governance Health Check shows that cyber security has become an enormous issue in the last few years and its importance continues to grow.

88% of participants include cyber in their "Risk Register" and 58% expect cyber risk to increase over the next year as 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 unauthorised 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 audit committees in the UK 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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"Audit committees have a critical role to play in ensuring that their organisations have robust cyber security defences – not in understanding the minutiae of the technology involved, but in leading governance and policy."

– Timothy Copnell
Chairman of the UK Audit Committee Institute

Audit committees 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 audit committees to ask and answer, and they should consider sharing best practices with colleagues on other boards.

Regulatory change and management

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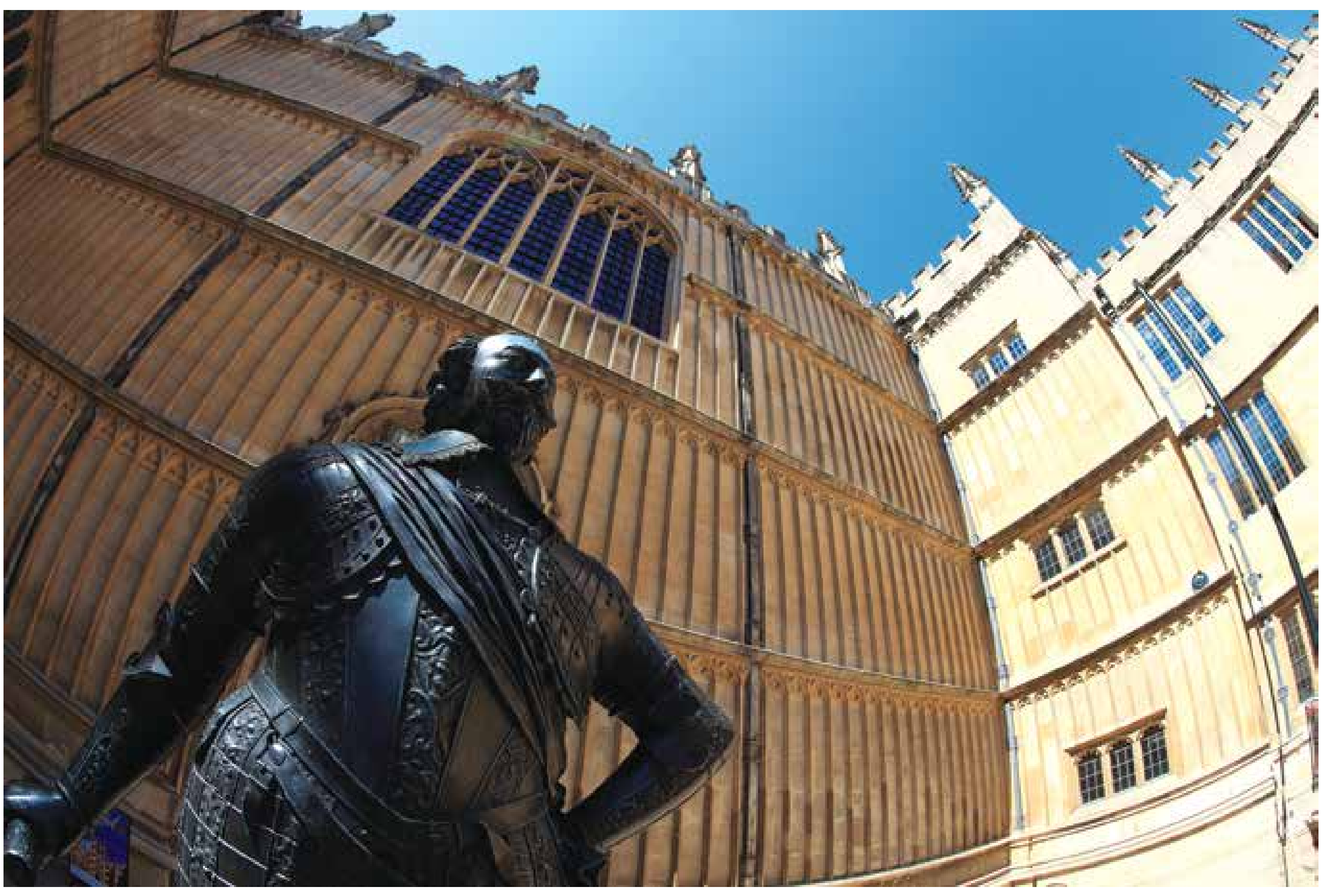
The impact of regulatory change following the corporate governance failings in the early 2000s cannot be overstated. Every industry has been affected by the focus companies put on the regulatory environment and compliance risk – not just around the audit, but in a growing number of other areas – has become the purview of the audit committee. As a result, audit committee 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 audit committee's mandate. Rather than filling in a checklist saying you've done what's required, audit committees would benefit from turning governance guidelines and regulatory requirements into best practices that are integrated and embedded throughout the organisation to deliver ongoing value and reduced risk to the company. Of course, given the number and complexity of regulations audit committees 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.

- EU audit reforms (including 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.
- The Competition and Markets Authority (CMA) Order requires that FTSE 350 companies put their statutory audit out to tender every 10 years for financial years beginning on or after 1 January 2015.
- The transitional provisions for the EU audit reforms and the CMA requirements are similar, but not the same. Under the EU reforms, the period as auditor before the year in which the company becomes a PIE is not included in the determination of audit tenure whereas new entrants to the FTSE350 are subject to the Order immediately upon the entry and so the determination of audit tenure includes the period before the company entered the 350.
- The latest UK Corporate Governance Code revisions come into effect for years beginning on or after 1 October 2014. There are now two required statements in relation to going concern, which differentiate between the accounting 'going concern' concept and the broader assessment of long-term solvency and liquidity, or 'viability'.
- The viability statement required by the UK Corporate Governance Code requires that the directors explain in the annual report how they have assessed the prospects of the company, what period the assessment covered, and why this period was appropriate. The period of analysis is expected to be greater than 12 months.
- The UK Corporate Governance Code revisions also note a requirement that the board (usually through the audit committee) distinguish between ongoing monitoring of the risk and control systems and the formal annual effectiveness review. The Financial Reporting Council do not see the board's involvement in relation to risk management and internal control systems as a once a year exercise.
- 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 controls.
- As one of the strictest regulations of its kind in the world, the UK Bribery Act requires additional attention from management in ensuring its requirements are met. Overseas regulations such as the US Foreign Corrupt Practices Act are also relevant as many have extraterritorial effect.
- Even export controls and sanctions are being enforced more stringently and are extending to a wider range of countries and sectors.

3

Globalisation issues

On top of the challenges imposed by the regulatory environment, several other issues related to globalisation are, or should be, showing up on the audit committee 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 incentivised to drive tax efficiencies (often in addition to operational efficiencies) by centralising or regionalising operations to these jurisdictions. This creates significant complexity and risks for companies since tax agencies are more active and aggressive than ever in opposing certain artificial transfer pricing strategies.

By generating large profits overseas, global transfer pricing strategies (whether aggressive or not) can create enormous political pressure and, in turn, politicians are pointing fingers at companies that engage in it. Multinationals with a significant international footprint and global 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 minimisation strategies foster the perception of multinationals not paying their fair share of taxes – including duty, excise and VAT – and being put at a significant advantage over purely domestic companies.

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. Of course, we know interest rates will rise in the future, but not when. That uncertainty has global implications. **However the stage is set for a very deliberate shift in monetary policy as central banks start to taper their purchases of government securities.**

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

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 companies from doing business with certain entities, while Argentina is beset by inflation and political instability, and audit committees 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.

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 'Strategic Report' and other narrative statements 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 annual report and accounts.

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"Whilst audit committees have traditionally looked over the whole annual report, the focus of their role has been largely around financial reporting, internal controls and going concern and in some cases the risk disclosures. The extension of the Board's formal role to ensuring that the whole annual report is "fair, balanced and understandable" has broadened, deepened and formalised many audit committees' oversight over the annual report. Increasingly we are also seeing audit committees taking an increasing role in ensuring the integrity and consistency of the whole gamut of corporate reporting, from the annual report to CSR reports to investor presentations."

– Jimmy Daboo

Partner KPMG in the UK

In the case of corporate responsibility reports, 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 International 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 their tax transparency disclosures.

As a leading 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 organisation's financial information.

By analysing 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 analyse 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, audit committees 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

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Internal evaluation and controls

One of the audit committee's core oversight duties is to ensure management's internal controls over financial reporting provide accurate and reliable information.

One trend has audit committees 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 audit committee in a timely manner, looks at the right risks and adds value to the company.

In another trend, audit committee chairs – faced with synthesising 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 a step further, some organisations, 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, 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 audit committees in discharging their mandates.

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

Going forward, audit committeess 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.

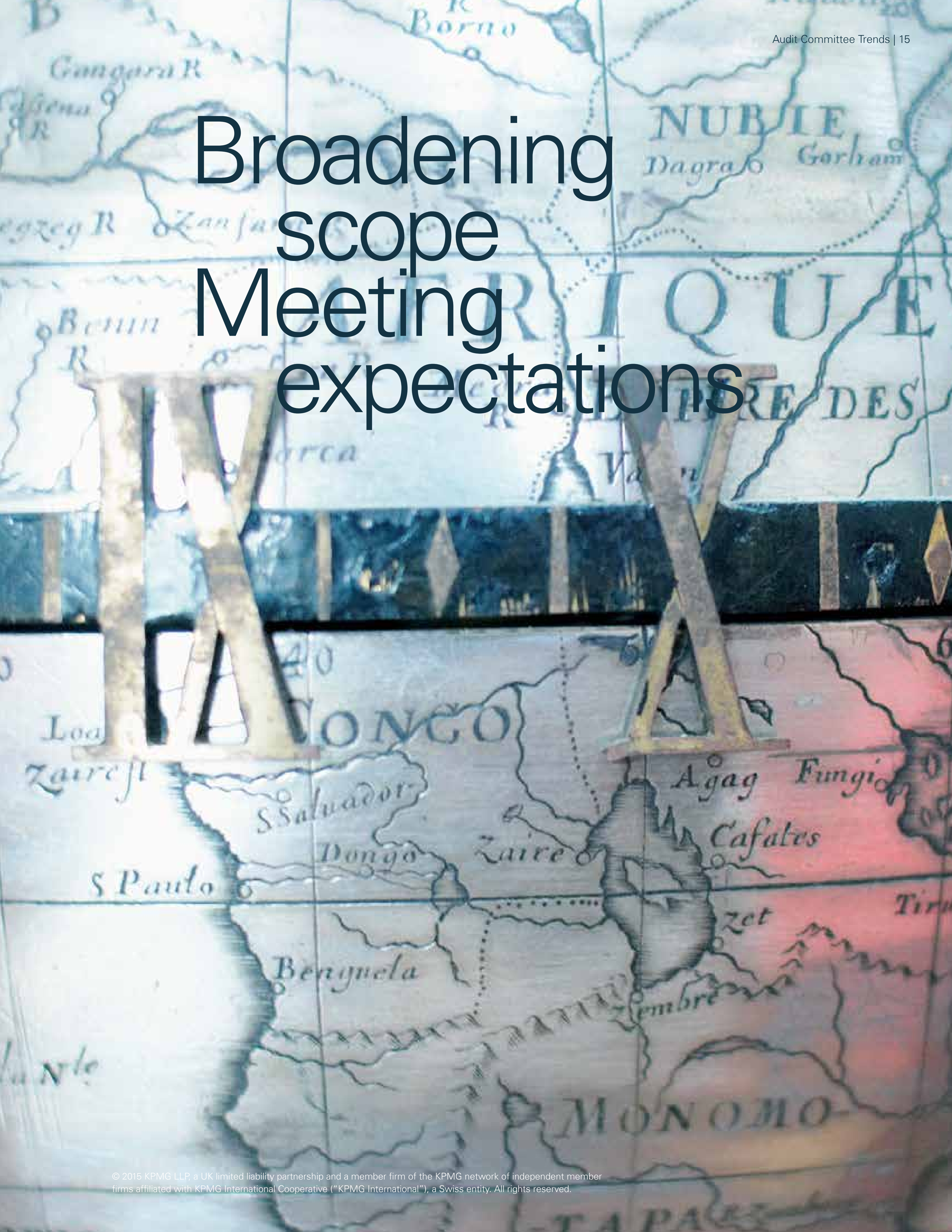
"At a time when audit committees are facing heavy agendas internal audit should be a vital voice on risk and control matters. Audit committees should consider the role that internal audit and third party review can play and whether this is best outsourced, managed in-house, or a combination."

– Tony Cates
Head of Audit KPMG in the UK

Audit committee checklist

Things to think about throughout the year

- ☐ Review the risk management process and assess management's response to risks
- ☐ Address social media, cyber security and IT issues to ensure reputational and business continuity risks are priorities
- ☐ Consider whether the financial statements and other disclosures tell the company's story – and the audit committee's. Ensure that investors are able to understand the financial performance and the company's goals and strategies
- ☐ Assess the financial risks facing the company (eg cash flow, access to capital etc)
- ☐ Monitor fair value estimates, impairments, and judgements of key assumptions underlying critical accounting estimates
- ☐ Understand the implications of the new revenue recognition standard and other accounting changes on the horizon
- ☐ Ensure the company's ethics, compliance and anti-bribery and corruption programmes are up to date in addressing the risks of fraud and misconduct
- ☐ Consider the role of internal audit within the organisation and how greater value can be added
- ☐ Keep up to date with the audit reform initiative and impact to the company (eg, when does the company need to put their external audit out to tender by?)
- ☐ Self-assess the audit committee's capabilities and make changes where necessary to strengthen diversity, risk experience and financial expertise



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.

Audit committees 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 audit committiees 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 audit committees 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 tendering and rotation, and a renewed focus on external audit reviews – audit committees 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.

Audit committees are striving to define their changing role and execute effectively on their evolving responsibilities. Regardless of how the Audit Committee agenda evolves, audit committees 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?

Why not also take a look at

- On the 2015 Audit Committee Agenda
- On the 2015 Board Agenda
- 2015 Global Audit Committee Survey
- Cyber security for audit committees
- Ethics and integrity blind spots and red flags

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About the Audit Committee Institute
Sponsored by more than 30 member firms around the world, KPMG's Audit Committee Institutes (ACIs) provide audit committee and board members with practical insights, resources and peer exchange opportunities focused on strengthening oversight of financial reporting and audit quality, and the array of challenges facing boards and businesses today – from risk management and emerging technologies to strategy and global compliance.

For more information on the work of the ACI please click on our web site
http://www.kpmg.com/uk/en/services/audit/pages/uk-audit-committee-institute.aspx

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