

# On the 2018 audit committee agenda

**Audit Committee Institute**

Financial reporting, compliance, and the risk and internal control environment will continue to be put to the test in 2018 - by slow growth and economic uncertainty, technology advances and business model disruption, cyber risk, greater regulatory scrutiny and investor demands for transparency, as well as dramatic political swings and policy changes in the UK, U.S. and elsewhere. Focused, yet flexible agendas - exercising judgment about what does and does not belong on the committee's agenda, and when to take deep dives - will be critical.

Drawing on insights from our recent survey work and interactions with audit committees and business leaders over the past 12 months, we've highlighted nine items that audit committees should keep in mind as they consider and carry out their 2018 agendas:



## Stay focused on job No. 1—financial reporting integrity:

In our [2017 Global Audit Committee Survey](#), nearly half of the 800 audit committee members who responded said it is "increasingly difficult" to oversee the major risks on the audit committee's agenda in addition to the committee's core oversight responsibilities (financial reporting and related internal controls, and oversight of internal and external auditors). Aside from any new agenda items, the risks that many audit committees have had on their plates for some time - cybersecurity and IT risks, supply chain and other operational risks, legal and regulatory compliance - have become more complex, as have the audit committee's core responsibilities. Reassess whether the committee has the time and expertise to oversee these other major risks. Does cyber risk require more attention at the full-board level - or perhaps the focus of a separate board committee? Is there a need for a compliance committee? Keeping the audit committee's agenda focused - and its eye on the ball - will require discipline and vigilance in 2018.



## Financial reporting quality starts with the CFO and the finance organization; maintain a sharp focus on leadership and bench strength:

In our global survey, 44 percent of respondents were not satisfied that their agenda is properly focused on CFO succession planning, and another 46 percent were only somewhat satisfied. In addition, few were satisfied with the level of focus on talent and skills in the finance organization. Given the increasing demands on the finance organization and its leadership - financial reporting and controls (including implementation of new accounting standards), risk management, analysing mergers and acquisitions and other growth initiatives, shareholder engagement, and more - it is essential that the audit committee devote adequate time to the finance talent pipeline, training and resources, as well as succession plans for the CFO and other key executives in the finance team. How is the finance team incentivized to stay focused on the company's long-term performance? What concerns do the internal and external auditors have about the talent and skills in the finance organization, including the organization's leadership?



### **Monitor implementation plans and activities for major accounting changes on the horizon – particularly the new revenue recognition and lease international accounting standards:**

The scope and complexity of these implementation efforts, and the impact on the business, systems, controls, and resource requirements, should be a key area of focus for audit committees. The new revenue standard (effective 1 January 2018 for calendar year-end companies) provides a single revenue recognition model across industries, companies, and geographical boundaries. While the impact will vary across industries, many companies - particularly those with large, complex contracts - will experience a significant accounting change when implementing the new standard. The new standard will require companies to apply new judgments and estimates, so audit committees will want to inquire about the judgment and estimates process, and how judgments and estimates are reached. Under the new lease standard (effective 1 January 2019 for calendar year-end companies) lessees will recognise most leases, including operating leases, on the balance sheet. This represents a wholesale change to lease accounting, and many companies will face significant implementation challenges during the transition. Implementation of these two new standards is not just an accounting exercise; audit committees will want to receive periodic updates on the status of implementation activities across the company (including possible trouble spots), the adequacy of resources devoted to the effort, and the plan to communicate with stakeholders.



### **Monitor the impact of the business and regulatory environment, as well as tone at the top and corporate culture, on the company's compliance programmes:**

In recent years, a number of highly publicised corporate crises that have damaged corporate reputations were due, in part, to failures to manage key risks posed by the company's culture, tone at the top, and incentive structures. Fundamental to any effective compliance program is the right tone at the top and culture throughout the organization, including a commitment to the company's stated values, ethics, and legal/regulatory compliance. This is particularly true

in a complex business environment, as companies move quickly to innovate and capitalize on opportunities in new markets, leverage new technologies and data, engage with more vendors and third parties across longer and increasingly complex supply chains, and, as a result, face heightened compliance risks.

Closely monitor the tone at the top and culture throughout the organization, and be particularly sensitive to early warning signs. Help ensure that the company's regulatory compliance and monitoring programs are up-to-date, cover all vendors in the global supply chain, and clearly communicate the company's expectations for high ethical standards. Take a fresh look at the effectiveness of the company's whistleblower program. Does the audit committee see all whistleblower complaints? If not, what is the process to filter complaints that are ultimately reported to the audit committee? As a result of the radical transparency enabled by social media, the company's culture and values, commitment to integrity and legal compliance, and brand reputation are on display as never before. Ask for internal audit's thoughts on ways to audit/assess the culture of the organization.



### **Focus internal audit on the company's key risks, beyond financial reporting and compliance:**

As recent headlines demonstrate, failure to manage key risks - tone at the top, culture, legal/regulatory compliance, incentive structures, cybersecurity, data privacy, global supply chain and outsourcing risks, and environmental, social, and governance risks, etc. - can potentially damage corporate reputations and impact financial performance.

The audit committee should work with the chief risk officer and head of internal audit to help identify the risks that pose the greatest threat to the company's reputation, strategy, and operations and to help ensure that internal audit is focused on these key risks and related controls. Is the audit plan risk-based and flexible? Does it adjust to changing business and risk conditions? What has changed in the operating environment? What are the risks posed by the company's digital transformation and by the company's

extended organization—sourcing, outsourcing, sales and distribution channels? Is the company sensitive to early warning signs regarding safety, product quality, and compliance? What role should internal audit play in auditing the culture of the company? Set clear expectations and help ensure that internal audit has the resources, skills, and expertise to succeed and help the head of internal audit think through the impact of digital technologies on the internal audit function.



#### **Continue to reinforce the audit committee's direct responsibility for the external auditor:**

Overseeing the auditor selection process including any tender process and auditor independence is a key part of an audit committee's role. Regular audit tendering and rotation is already 'business as usual', but the new regulatory regime includes some requirements that are difficult to navigate and in some cases will significantly impact the way audit committees of Public Interest Entities (PIEs) operate in practice. Read the [ACI's Audit Tendering Guide](#) to help ensure the tender process is carried out in an efficient and effective manner and can deliver lasting benefits to your company. To ensure the auditor's independence from management and to obtain critical judgment and insights that add value to the company, the audit committee's direct oversight responsibility for the auditor must be more than just words in the audit committee's terms of reference or items on its agenda. All parties, the audit committee, external auditor and senior management, must acknowledge and continually reinforce this direct reporting relationship between the audit committee and the external auditor in their everyday interactions, activities, communications and expectations.



#### **Give non-GAAP financial measures a prominent place on the audit committee agenda:**

Following ESMA's final report on alternative performance measures (APMs) and others have expressed concern about the undue prominence given to alternative performance measures over

the equivalent IFRS measures. While alternative performance measures can provide valuable insight into a company and the extent to which its business model is successful, the way alternative performance measures are presented and how they relate to the information presented in the financial statements should have a prominent place on the audit committee agenda. Have a robust dialogue with management about the process and controls by which management develops and selects the alternative performance measures it provides, their correlation to the actual state of the business and results, and whether the alternative performance measures are being used to improve transparency and not distort the balance of the annual report.

What broader drivers of value that contribute to the long-term success of the company should be disclosed? What sources of value have not been recognized in the financial statements and how are those sources of value managed, sustained and developed (for example, a highly-trained workforce, intellectual property or internally-generated intangible assets, where these are relevant to an understanding of the company's development, performance, position or impact of its activity).



#### **Engage in early and open communication with the auditor on the new enhanced audit reports:**

There continues to be significant discussion internationally about the need for increased transparency by the external auditor around the audit process. Under International Standards on Auditing (ISA 701) – while retaining the pass/fail model – auditors are now required to describe in the audit reports of listed entities the key areas they focused on in the audit and what audit work they performed in those areas. In the U.S., the PCAOB issued a final standard on the auditor's reporting model which requires a description of "critical audit matters" in the auditor's report. Auditors may have the primary responsibility for implementing the requirements, but they are relevant to and affect other stakeholders as well, in particular the audit committee. Audit

committees should interact comprehensively with the auditor from the audit planning stage through to the finalization of the audit report. In particular, consider whether disclosures in the financial statements or elsewhere in the annual report and/or in other investor communications need refreshing, otherwise the auditor might be disclosing more information about an item than the company. Engaging in early and open communication with the auditor is crucial in this regard.



#### **Make the most of the audit committee's time together - effectiveness requires efficiency:**

As noted previously, keeping the audit committee's agenda focused on financial reporting and related internal control risk is essential to the committee's effectiveness, but meeting the workload challenge also

requires efficiency. Streamline committee meetings by insisting on quality pre-meeting materials (and expect pre-meeting materials to have been read), making use of consent agendas, and reach a level of comfort with management and auditors so that routine financial reporting and compliance activities can be "process routine" (freeing up time for more substantive issues). Does the committee leverage the array of resources and perspectives necessary to support its work? Does the committee spread the workload by allocating oversight duties to each member, rather than relying on the committee chair to shoulder most of the work? Does the committee spend time with management and the auditors outside of the boardroom to get a fuller picture of the issues? Take a hard, honest look at the committee's composition, independence, and leadership. Is there a need for a fresh set of eyes? Is it time for a rotation?

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