



# On the 2018 Audit Committee agenda

**Audit Committee Institute**  
part of KPMG Board Leadership Centre

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, US 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 twelve months, we've highlighted ten items that audit committees should keep in mind as they consider and carry out their 2018 agendas:

- 1. Stay focused on the 'number one' job — 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 - cyber security 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.
- 2. Financial reporting quality starts with the CFO and the finance team; 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 team. Given the increasing demands on the finance team 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 incentivised 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 team, including the organisation's leadership?

- 3. 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.

4. **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 organisation - 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.

5. **Reinforce the audit committee's direct responsibility for the external auditor:** Overseeing the auditor selection process including any (mandatory) 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 (PIE) 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 judgement 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.

6. **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 programme is the right tone at the top and culture throughout the organisation, 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 capitalise 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 organisation, and be particularly sensitive to early warning signs. Help ensure that the company's regulatory compliance and monitoring programmes 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 organisation.

7. **Give non-GAAP financial measures a prominent place on the audit committee agenda:** Following ESMA's final report on alternative performance measures (APMs) published in 2015, the FRC 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 recognised 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).

8. **Risk reporting and viability statements:** The introduction of viability statements in the 2014 UK Corporate Governance Code has brought a greater focus on risk management at board level which has contributed to recent improvements in risk reporting. Nevertheless, further improvements in this area remain a key priority for investors and the FRC. Much of the commentary around viability reporting has focused on the period over which the board has chosen to make its statement which, in the majority of cases, has been three years. The period is often selected to reflect a company's medium-term business plan. However, audit committees (and boards) should take into account other factors such as investment and planning periods, the board's stewardship responsibilities, the nature of the business and its stage of development and previous statements made, especially in raising capital. Investors are calling for greater differentiation of the time periods used by different companies and sectors, in light of these other factors.

Consider developing the viability statements in two stages – first, to consider and report

on the prospects of the company over a period reflecting its business and investment cycles, and second, to state whether there is a reasonable expectation that the company will be able to continue in operation and meet its liabilities as they fall due over the period of the assessment, drawing attention to any qualifications or assumptions as necessary. The FRC's Financial Reporting Lab have identified some examples of good practice following this approach which clearly explain the underlying analysis that supports the statement.

9. **Audit committee reports:** There is increased focus from both regulators and investors on the quality of the audit committee's report, particularly around the disclosures relating to the audit committee's consideration of the significant financial reporting issues and the external audit relationship – including the committee's role in the appointment, reappointment or removal of the external auditor.

Consider expanding the audit committee's report to provide investors more insight into how the committee carries out its oversight responsibilities, particularly its role in helping to maintain audit quality. Does your audit committee report enhance investor confidence in audit and the oversight discharged by the committee? Does your report focus on matters specific to your company and to the current year; say what you did (not just what you do) and depict the specific activities during the year and their purpose, using active, descriptive language? Does the report describe issues and their context, policies, processes, conclusions and their consequences for the company and its reporting? Does the report disclose judgement calls made for the year, and the sources of assurance and other evidence drawn upon to satisfy the committee of the appropriateness of the conclusion? Will the reader understand how the committee has made a difference and added value?

10. **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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