Audit committees during the coronavirus crisis

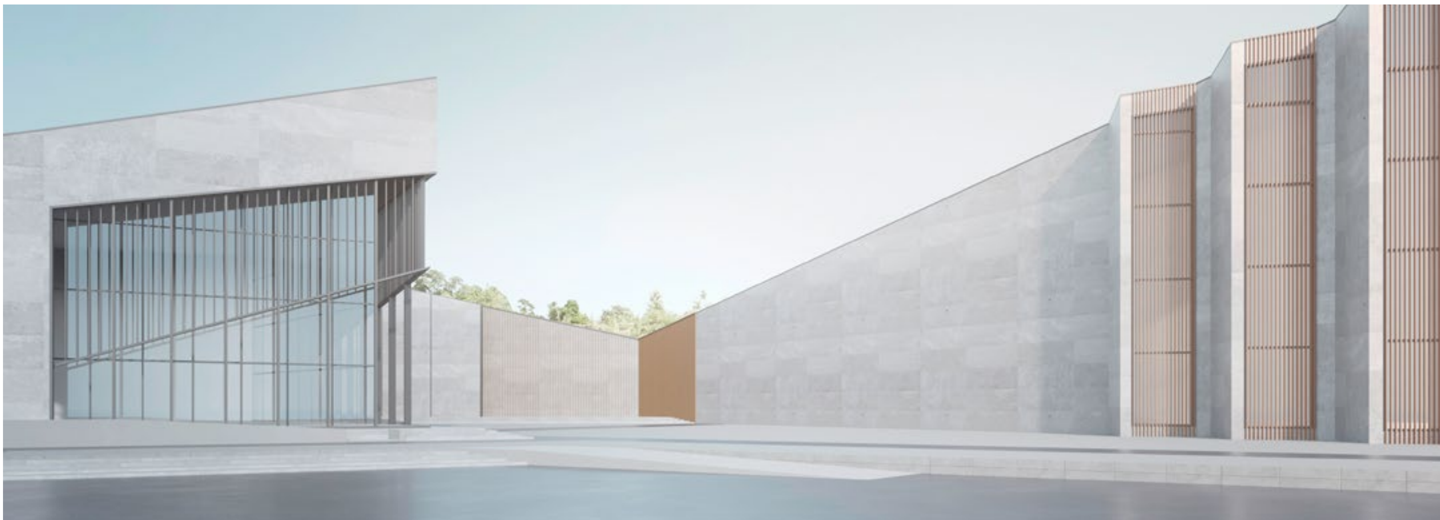
The coronavirus crisis is not over yet. Nevertheless, we can look back at the events of the past nine months and draw some conclusions: What were the biggest challenges facing audit committees? Which accounting-related issues were most urgent? And what impact did these have on audits? Which insights will continue to hold true even after the coronavirus crisis has subsided? We discussed these issues with the members of several audit committees.

The importance of audit committees for ensuring good corporate governance is undisputed. Only smoothly functioning collaboration between all parties involved in monitoring and control can help protect what might be a company's most important asset: trust. The audit committee's work has become more challenging than ever during the coronavirus crisis. At many companies and organizations, ensuring business continuity management took top priority during the first few months of the year. This involved a wide range of issues that extended far beyond the purely financial aspects of their activities and included protecting their employees' health, procurement chains and communication (both internally and externally). Once the lockdown was over, the big question was whether or not people should return to their workplaces. The answers to these questions and challenges differed widely, also from one company to another: While the impact on the travel and aviation industries was extreme, diversified industrials are probably only experiencing temporary effects and a few individual companies in the life science industry are even posting very good half-year results. But what do they have in common?

Looking back at the 2019 annual financial statements and interim financial reporting

At the beginning of this year, the most pressing question was how the repercussions of the coronavirus crisis should be disclosed in the annual financial statements for 2019. Since it is an event after the balance sheet date, the most common accounting standards call for a disclosure in the notes and for details to be included in the management report. In light of the extraordinary nature of the circumstances, the board of directors' responsibility to issue an assessment on the company's ability to continue as a going concern was a particularly important one. If any material uncertainties had existed in this respect, these should have been disclosed in the notes to the annual financial statements.

The relevant audit-related topics were at least in part a reflection of the accounting matters mentioned: Besides having to deal with the challenges that arose in connection with the travel



restrictions imposed, disclosures regarding events after the balance sheet date and assumptions regarding a company's ability to continue as a going concern took priority. For publicly traded companies the audit report and key audit matters contained therein were also material. Since the difficult circumstances encouraged criminal activities, as well, different approaches had to be adopted both with respect to how fraud risks are assessed and to the respective audit procedures.

Which were the biggest challenges faced by audit committees?

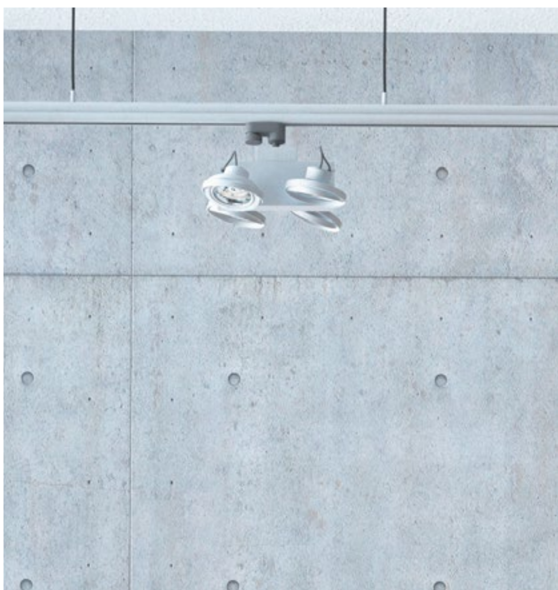
They first had to focus on coping with the challenges already mentioned (health concept, capacity to continue as a going concern, supply chains and customer relationships). While hygiene regulations meant that manufacturing companies were unable to run their factories at capacity, even despite demand for their products, some of them also lacked the parts and products they needed due to the fact that China's economy had been nearly paralyzed at the start of the year. It was foreseeable that the sales slump would make safeguarding liquidity a priority. Not only could annual general meetings not be held as planned, but intended dividend distributions also had to be reconsidered and adjusted as needed.

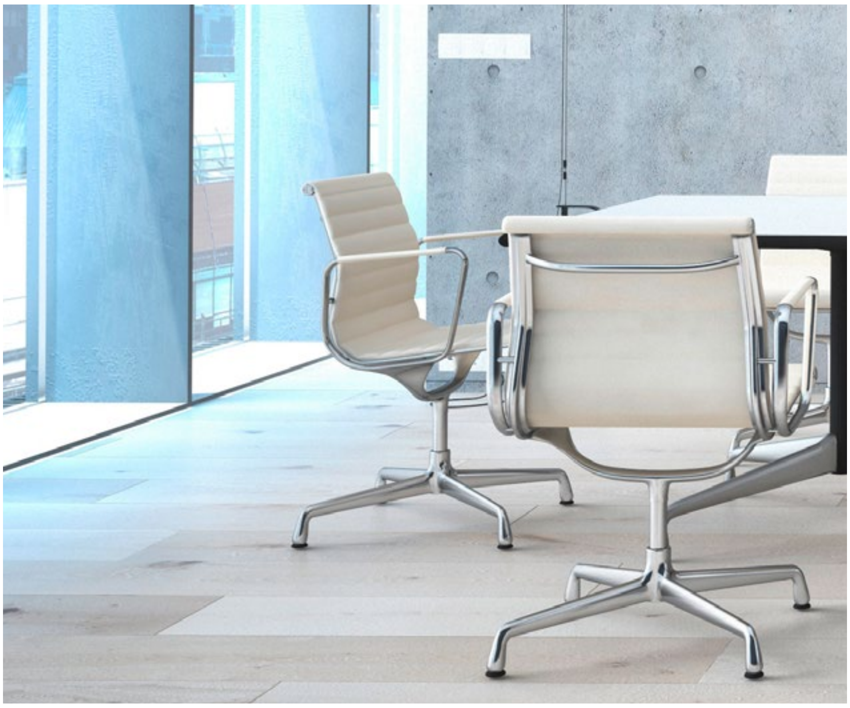
In the medium to long term, the economic environment will prove extraordinarily challenging for many enterprises. Added to that is the fact that the uncertainties triggered by geopolitical upheavals are overlapping the repercussions of the coronavirus crisis. Companies have started to refrain from issuing any more forecasts and are coming up with potential scenarios instead of elaborate plans. At the same time, certain companies have taken immediate steps to adapt some aspects of their previous business models or are working on doing so, whether as part of plans that have already been in place for some time now or as a result of the coronavirus crisis.

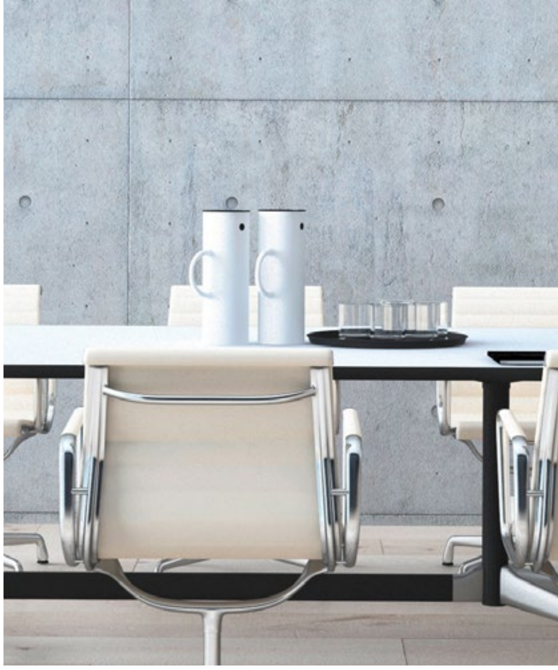
Outlook on the 2020 annual financial statements

Given the cautiously positive outlook, most companies should be able to continue as a going concern. Nevertheless, hard-hit industries can be expected to show signs of impairment, which make impairment testing necessary. In this context, it will be interesting to see just how willing companies are to provide meaningful information in the notes regarding sensitivities and their discretionary power with respect to valuations. Another related question is whether the impact of the coronavirus pandemic on the income statement should be reported in the extraordinary result: While this is not even allowed under IFRS, most expense (but also income) items do not actually meet the corresponding criteria under Swiss GAAP FER, either. Besides being disclosed transparently in the notes and including a comment in the management report, another conceivable approach could also be to report on the situation using alternative performance measures. Formulating statements regarding future prospects will pose a major challenge: While these outlooks are highly relevant for investors and analysts, the companies will likely be reluctant to make any statements (and any information they do provide will be more or less detailed as a result).

If COVID-19 loans or COVID-19 Plus loans were taken out in Switzerland, special attention should be paid to the requirements that the federal government ties to such loans (especially given the liability provisions that apply to board members). The situation is likely to be similar in many other countries that have attached special conditions to emergency loans (like the CARES Act of 27 March 2020 in the US).







What impact will this have on cooperation with auditors?

One trait that characterizes good corporate governance is a balanced relationship between leadership and control. To establish that, the audit committee assesses the proper functioning of the internal control system and that of internal audit, risk management and compliance. COVID-19 illustrated the importance of the interplay between these so-called assurance providers, one of which being the external auditor. Not only was the interplay between these assurance providers put to the test, but it also had to be fine-tuned due to the sudden emergence of new risks. Since neither internal nor external auditors were able to travel or conduct audits on site, at least not during the lockdown, immediately switching to a digital approach for conducting audit procedures generally worked. This was also the approach taken for reviewing interim financial statements. It also became apparent, however, that video conferences cannot completely replace personal contact. Being able to look the other person in the eye and observe their reactions is a must from time to time and for certain matters (e.g. fraud interviews). With respect to auditing the 2020 annual financial statements, the question of how to deal with professional requirements that demand an auditor’s on-site presence arises (e.g. when taking inventory).

The swift transition to performing remote audits was probably fairly smooth because the parties involved had already had an opportunity to get to know one another and work together for a while prior to the pandemic. This personal contact then formed the basis for a trust-based continuation of this work in the digital sphere. Where appropriate, the experience gained through this collaboration is now to be used to intensify the focus on digitalization; this will take the form of increasingly digital processes in companies whereas auditing firms will employ additional data analytics tools. At the same time, however, they have recognized the enormous value of on-site collaboration. Personal contact is still necessary for many reasons and still needs to be cultivated. It is only logical for auditing firms to think about how to ensure these indispensable interpersonal communications within the audit team when auditing the 2020 financial statements. The audit teams of global clients could meet together at the audit firm’s local office or at rented premises, for example (under consideration of the then valid travel regulations/restrictions). Personal meetings with audit committees are desirable and important to auditors for similar reasons.

Which insights will continue to hold true even after the coronavirus crisis has subsided?

With respect to their liquidity management, many companies were caught off guard during the financial crisis of 2008. The right lessons were learned (at least wherever possible). Also interesting to note is the fact that many enterprise risk management systems either did not include pandemics as risks or, if so, they were not analyzed as carefully or seriously as needed. The result was a distinct lack of contingency plans. Since preparing for every single risk is impossible, those enterprises that weathered the crisis well were the ones that were able to respond flexibly enough when the need arose. One pivotal factor in many cases was the creation of a crisis committee that held the reigns and served as a one-stop source of information – both internally and externally. Robust internal processes were another crucial component; these enabled businesses to rapidly switch to a virtual environment and decision-making bodies to concentrate fully on their operations and crisis management – calmly and collectedly.

From a strategic perspective, you might say that diversification ended up being the winner. Investors and analysts may have regularly criticized broadly diversified activities in the past, yet spreading risks can be advantageous, particularly in uncertain and difficult times. The events of the first half year have prompted many enterprises to question their strategy in this regard. Some took immediate action and parted with areas that held little future potential, while others are still busy assessing their portfolios and adjusting them as needed. Many of these discussions will revolve around supply chains: Are a company's own production facilities in the right geographic location? Is it possible to use other suppliers (second sourcing)? Are purchase and supply agreements designed with provisions that take such extreme situations into account to the greatest possible extent (e.g. with respect to penalties)?

These questions essentially revolve around the need to strengthen resilience of the company, not only as a whole but also that of its individual components and of its employees. Decisive roles are played not only by the design of businesses' infrastructures but also by their corporate cultures and underlying value management. These aspects are not only important in terms of managing the next crisis, but also with respect to changing working models and workplaces. With that in mind, this crisis – just like any other crisis – can be viewed both as an opportunity and a catalyst. The coronavirus crisis has given a boost to digitalization in many companies and, according to a recent publication from McKinsey, digitalization will also form part of the solution ("The recovery will be digital"). It additionally helped prompt greater scrutiny of traditional notions of mobility, workstations and work/life balance, for example, all of which are issues considered important by young employees. In that respect, the hope is that we can also extract something positive from this crisis and emerge stronger, not only as a company but as a society, as well.

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