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How are audit committees preparing for emerging financial reporting and compliance matters?

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As we address the year-end reporting cycle, the persistent uncertainty in the business environment, along with increased complexities and higher risk profile, could necessitate a high degree of judgement and oversight for the audit committee.

The audit committee's responsibilities range from reviewing the financial statements and auditor's reports to approving Related Party Transactions (RPTs), scrutinising inter-corporate loans and investments, assessing internal financial controls, and investigating whistleblower complaints. Considering the developments that have taken place in the regulatory and legal environment, the audit committee members and board of directors should be mindful of certain critical amendments having an impact in the upcoming year for which necessary procedures should be in place.

Revenue recognition

Revenue recognition remains one of the most complex and scrutinised aspects of financial reporting. It is important that the revenue recognition practice of the company align with the applicable framework especially in areas requiring significant judgment such as timing and measurement of revenue from multi-element arrangements, bundled services, and Software-as-a-Service (SaaS) contracts for companies in technology sector. The mounting pressure to meet earnings expectations, combined with ‘shades of grey’ and increased scrutiny from both internal and external auditors sometime perhaps underscored the complexities around revenue recognition practices.

Audit committees should remain vigilant in overseeing revenue recognition processes and internal controls. They should ensure consistency and transparency across business models, especially in reviewing revenue recognition methodologies for long-term contracts or multi-element arrangements and ensuring alignment with the relevant accounting framework. Additionally, audit committees expected to address discrepancies between forecasted and actual revenue, particularly where estimates and assumptions are involved, to mitigate risks. A proactive approach is crucial for maintaining stakeholder trust and financial reporting integrity.

Monitor Related-Party Transactions (RPTs) and related compliance under various laws

While Related Party Transactions (RPTs) are a normal feature of commerce and business, they may give rise to specific risks of material misstatements of financial statements, including risk of fraud because of the nature of related party relationships.

Considering the criticality of the area, regulators and standard setters have predominantly exercised oversight on RPTs through persistent revision in SEBI Listing Regulations and the Companies Act (2013 Act) including provisions for obtaining approval from audit committee/shareholders for RPTs elevating the responsibilities of independent directors to exercise rigorous due diligence and obtain relevant justifications.

Recent regulatory scrutiny has revealed issues such as opaque pricing, delayed disclosures, and insufficient documentation, particularly during year-end periods. Additionally, many related parties operate via an extensive and complex network of relationships making them difficult to unravel. It is thus imperative for audit committees to ensure proper systems are in place for identification, recording and analysis of related parties and arm's length pricing of related party transactions as management should be made responsible to identify and disclose all related party relationships and transactions. The audit committees may use reinforce requirement for approval of RPTs, may encourage the use of external benchmarking and expert valuation reports in certain scenarios particularly when there are concerns about pricing, fairness, or structure of transactions or related parties. Further, audit committees are expected to ensure proper documentation of all deliberations, justifications, and decisions related to RPTs to withstand regulatory scrutiny.

Balancing automation and controls/assurance objectives

Organisations are increasingly automating and digitising their processes to achieve efficient and effective operations, enhancing speed and agility. Automation within finance function provides greater insights, reduces the time of repetitive activities, results in efficiency and enables the team to focus on the core activities resulting in business value enhancements. While these technologies offer efficiency and scalability, they also introduce risks, including data integrity issues, system dependencies, script errors, and the complexity of black-box algorithms. Further, with regulators increasingly demanding system-based audit trails and digital documentation, companies are required to invest in infrastructure that supports real-time dashboards, audit logs, and robust exception reporting.

In this evolving environment, audit committees are expected to expand their oversight to include technology assurance. Further, audit committees should ensure detailed walkthroughs of digital reconciliation structures, tools, platforms, and human validation points. Committees should ask if work performed by bots or algorithms are subject to internal audit validation and if exception logs are reviewed periodically. During ERP migration or implementation of new systems, audit committees should review whether robust reconciliation testing, and parallel runs were conducted. Additionally, any kind of failures, mismatches, or data integrity issues must be escalated promptly and systematically to the audit committee.

Determining the extent of reliance on external expert input and audit committee judgment

In today's complex regulatory and legal environment, audit committees seek help from the external experts like legal counsel, valuers, actuaries, or tax advisors for informed judgments. However, this reliance does not absolve the committee of its oversight responsibilities.

Recent regulatory actions have highlighted the risks of accepting expert opinions without inquiry or challenge, exposing the board to significant compliance and reputational risks. Therefore, it is important to balance the use of expert insights for robustness without overdependence. Audit committees are expected to scrutinise expert advice, understand its assumptions and scope, and verify its alignment with internal records and ensure that the scope of expert advice is clearly defined. In complex scenarios, especially involving regulatory interpretation, cross-verification or second opinions should be encouraged.

The audit committee may request management to have direct access to the expert team, avoiding management filters to prevent distortion or misrepresentation. As regulators increasingly examine board documentation and decision rationale, the quality of engagement with experts, especially the nature of questions posed, becomes crucial in hindsight assessments or regulatory investigations.

Review of important documents

The audit committee plays a crucial role in addressing emerging financial reporting and compliance issues. As guardians of financial integrity, they are expected to implement proactive strategies to ensure thorough preparedness. To enhance the reliability of financial reporting, the audit committee can review the management representation letter, CEO/CFO Certification, and OFIs raised by statutory auditors. The management representation letter confirms the accuracy and completeness of the financial statements, while the CEO/CFO certification affirms their integrity and provides assurance regarding internal controls. Additionally, addressing Observations, Findings, and Issues (OFIs) identified by statutory auditors is critical to strengthening the financial reporting and compliance frameworks.

The review of these important documents by the audit committee demonstrates a commitment to continuous improvement and adherence to high standards. By thoroughly examining management representation letters, CEO/CFO certifications, and OFIs raised by statutory auditors, the audit committee fosters confidence among stakeholders and ensures compliance with evolving regulations and standards. These proactive strategies enhance the reliability of financial reporting and strengthen the company's financial integrity.

Aligning board composition with evolving oversight demands

Effective board composition is crucial for ensuring that audit committees can provide robust oversight of financial reporting, compliance, and risk. As regulatory demands, digital disruption, ESG priorities, and stakeholder activism intensify, companies must reassess whether their board composition particularly within audit committees is equipped to address these matters. To effectively navigate the complexities of today's business environment, audit committee members are expected to possess expertise in financial reporting, regulatory compliance, and risk management, alongside independence and strategic insight. Therefore, the ACs are also required to assess on continuous basis whether they have the right composition and skill sets. This involves thoroughly assessing current skills and proactively addressing any gaps. The composition of the AC should be high performing members with the right skill sets and professional experience.

In this respect, audit committee chairs may work with board and management to map current skills of members against future needs, encourage planned succession, ensure ongoing education, and foster a culture of active engagement. This comprehensive approach could enable audit committees to navigate the complexities of the modern business environment and provide robust oversight.

Expanding landscape of financial and non-financial disclosures

Corporate disclosure has transformed from a mere statutory obligation into a powerful strategic lever for fostering transparency, enhancing investor trust, and encouraging market reputation. This paradigm shift places heightened responsibilities on audit committees, compelling them to ensure that a wide spectrum of financial and non-financial disclosures incorporating ESG metrics, cyber risks, segmental performance, and whistleblower updates - are accurate, timely, and relevant to stakeholders. With increased scrutiny from regulators and tightening of regulatory requirements audit committees should closely validate internal reporting systems and ensure consistency in communication to stakeholders. Additionally, by focusing on transparency, accountability, and effective governance, audit committees can help build investor trust, maintain market reputation, and support the strategic objectives of the company.

The bottom line

In conclusion, the role of audit committees has expanded beyond traditional financial oversight due to the increasingly complex and dynamic governance environment. The themes discussed in the document highlight pressing challenges, emerging trends, and evolving regulatory demands that require careful attention. Audit committees can effectively safeguard stakeholder interests and contribute to long-term corporate success by staying proactive, enhancing their understanding of critical issues, and fostering a culture of transparency.

We would like to thank our audit committee council members for their time in providing us with their valuable insights and perspectives that have contributed to building this point of view document.

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