Audit Committee Institute

On the 2019 Audit Committee agenda

Audit committees can expect their company's financial reporting, compliance, risk and internal control environment to be put to the test in the year ahead. Among the top challenges and pressures: long-term economic uncertainty (with concerns about Brexit, mounting trade tensions, resurging debt, and market valuations), technology advances and business model disruption, cyber risk, regulatory scrutiny and investor demands for transparency, and political swings and policy changes in the US, UK, and elsewhere.

Drawing on insights from our 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 2019 agendas:

1. Take a fresh look at the audit committee's agenda and workload

We continue to hear from audit committee members that it is increasingly difficult to oversee the major risks on the committee's agenda in addition to its 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 - cyber security and IT risks, supply chain and other operational risks, legal and regulatory compliance - have become more complex, as have the 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 a separate board committee? Is there a need for a compliance or risk committee? Keeping the audit committee's agenda focused will require vigilance.

2. Sharpen the company's focus on ethics and compliance

The reputational costs of an ethics or compliance failure are higher than ever. Fundamental to an effective compliance programme is the right tone at the top and culture throughout the organisation - one that supports the company's strategy and commitment to its 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, and engage with more vendors and third parties across longer and increasingly complex supply chains. Closely monitor the tone at the top and culture throughout the organisation with a sharp focus on behaviours, not just results. Help ensure that the company's regulatory compliance and monitoring programmes are up-to-date and cover all vendors in the global supply chain, and clearly communicate the company's expectations for high ethical standards. Focus on the effectiveness of the company's whistle-blower reporting channels and investigation processes through a #MeToo lens. Does the audit committee see all whistle-blower complaints and how they have been addressed? 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 its brand reputation are on display as never before.

3. Understand how the finance team will reinvent itself and add greater value in this technology and data-driven environment

Over the next two years, we expect finance functions to undergo the greatest technological transformation since the 90's and the Y2K ramp-up. This will present important opportunities for finance to reinvent itself and add greater value to the business. As audit committees oversee and help guide finance's progress in this area, we suggest several areas of focus.

First, recognising that the bulk of finance's work involves data gathering, what are the organisation's plans to leverage robotics and cloud technologies to automate as many manual activities as possible, reduce costs, and improve efficiencies? Second, how will finance use data and analytics and artificial intelligence to develop sharper predictive insights and better deployment of capital? The finance function is well-positioned to guide the company's data and analytics agenda - and to consider the implications of new transaction-related technologies, from blockchain to crypto-currencies. As historical analysis becomes fully automated, the organisation's analytics capabilities should evolve to include predictive analytics, an important opportunity to add real value. Third, as the finance function combines strong analytics and strategic capabilities with traditional financial reporting, accounting, and auditing skills, its talent and skill-sets must change accordingly. Is finance attracting, developing, and retaining the talent and skills necessary to deepen its bench strength and match its evolving needs? It is essential that the audit committee devote adequate time to understand finance's transformation strategy.

Also stand back and think about how the investor community views the management team. In hard times, (say) when a rescue rights issue is needed, the two key questions that need to be answered are "is the business worth saving" (this is the one most Boards will be focused on) and "is this management team investable". If the answer to either is "no" then there will be no support. This is relevant to the audit committee's / board's consideration of risk, going concern and viability (see later), as well as more broadly.

4. Monitor corporate reporting as well as progress on implementing new standards

The scope and complexity of implementation efforts for the new IASB standards and the impact on the business, systems, controls, disclosures, and resource requirements should be a key area of focus.

With calendar year-end companies reporting under the revenue recognition standard for 2018, the Irish Auditing and Accounting Supervisory Authority (IAASA) and the Financial Reporting Council (FRC) have encouraged companies to invest sufficient time during their year-end preparation to ensure that:

- explanations of the impact of transition are comprehensive and linked to other relevant information in the annual report and accounts;
- Policy changes are clearly described and explained, reflecting company specific information – as are any associated management judgements;
- performance obligations, a new concept introduced by IFRS 15, are identified and explained, with a focus on how they have been determined and the timing of delivery to the customer; and
- the impact of the standard on the balance sheet is also addressed, including accounting policies for contract assets and liabilities.

Also, for some companies, implementation of the revenue standard involved both manual processes and enabling technology and tools. Manual work-arounds should not become permanent. Audit committees will want to help ensure that any work-arounds are automated as soon as possible.

IFRS 9 *Financial Instruments* – also effective for December 2018 year ends - will have the greatest impact on banks. However, all companies should be analysing the implications of adoption and considering the adequacy of transition disclosures. While the nature and extent of preparations will vary, companies need to thoroughly evaluate the effect of the standard and determine what changes are necessary. Companies may need to collect more data, update their documentation and significantly change their systems, processes, and internal controls.

Looking forward, the new leasing standard (IFRS16) is almost here - periods beginning on or after 1 January 2019 - and companies should now be in a position to explain the impact of the new requirements in their December 2018 annual reports. The regulators expect companies to provide meaningful information about the application of the standard with a focus on their specific circumstances; to disclose qualitative and quantitative information, identifying any lease portfolios that are significantly impacted; to explain the specific judgements and policy changes prompted by the new model and provided detail about the structure of their implementation projects; and to identify the exemptions that companies intend to apply.

Finally, take time to stand back and reflect on whether the financial statements are really "true and fair" as the 'public' would expect. Is the annual report really "fair, balanced and understandable"?

Think about all the awkward things where there might be some reluctance to be open. And keep at least a weather eye on what your key investors are thinking. Some investors are becoming increasing vocal about what they want to see in corporate reporting - at a general level, at a sector level and at individual company level - but this may not be communicated directly to the audit committee or the CFO.

5. Reinforce audit quality by setting clear expectations for the 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.

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.

Think about how technology innovation might drive the quality of the external audit and whether the audit firm is making the most of the opportunities available.

Also keep an eye on the febrile state of the audit market and the potential impact in the UK of the Kingman review of the FRC and the CMA study of the statutory audit market on both the committee and the external auditor.

6. Give non–GAAP financial measures a prominent place on the committee's agenda

Non-GAAP measures are still high on the Regulators' agenda and they set a clear expectation that companies should adhere to ESMA's Guidelines on alternative performance measures (APMs).

Have a robust dialogue with management about the process and controls by which management develops and selects the alternative performance measures it provides.

Also 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? (E.g. 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).

Also, think about the new non-financial information statement which should include information relating to environmental matters, employees, social matters, respect for human rights and anti-corruption and anti-bribery matters. For companies within the scope of the new requirements, there is an expectation that the disclosure focuses on the policies the company has in place, any due diligence processes introduced through which it assesses and tracks their effectiveness and the related outcomes.

7. Focus internal audit on the company's key risks and controls – including those beyond financial reporting and compliance

As recent headlines demonstrate, failure to manage key risks - such as 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 - can potentially damage corporate reputations and impact financial performance.

The audit committee should work with the Head of Internal Audit to help identify the risks that pose the greatest threat to the company's reputation, strategy, and operations and help ensure that internal audit is focused on those risks and related controls. As business environmental change accelerates, think specifically about horizon scanning and those existential risks that seem to emerge where none appeared imminent even a year ago (e.g., high street retail).

Is the audit plan risk-based and flexible enough to adjust to changing business and risk conditions? Have there been changes 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? Is internal audit helping to assess and monitor the company's culture?

Set clear expectations and help ensure that internal audit has the resources, skills, and expertise to succeed and help the chief audit executive think through the impact of digital technologies on internal audit.

Finally, think about how internal audit might leverage new technology and innovation. This receives less attention than technology within the external audit but probably presents the greater opportunity to both move to a continuous assurance model and enhance the quality of overall assurance.

8. Risk reporting and viability statements

Risk and viability reporting remains an area of focus for investors. The introduction of viability statements in the UK has brought a greater focus on risk management at board and senior management level, enabling many companies to make more informed decisions about their risk appetite. However, viability statements are yet to deliver all the external benefits expected when they were introduced. Although some companies have enhanced their disclosure this year, many are still not explaining the processes that they have undertaken to prepare their statement, including the stress and scenario testing they have carried out.

Viability reporting should be based on a robust assessment of the principal risks that would threaten the business model, future performance, solvency or liquidity of the company. Encourage the application of a two-stage process: firstly, assessing the future prospects of the company; and secondly, disclosure as to whether directors have a reasonable expectation that the company will be able to continue to operate and meet its liabilities as they fall due (potentially over a shorter period), drawing attention to any qualification or assumptions as necessary. Examples of how this has been applied by companies are included in the Financial Reporting Lab's 2018 Implementation Study.

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 ensure audit scepticism and 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. Pay particular attention to the risks and reporting consequences associated with Brexit

Although many companies may now be well advanced in developing their strategy and impact assessment in response to Brexit, we still face significant uncertainties and unknowns in respect of the final deal that may be struck. This situation poses particular challenges for companies as they prepare for their December 2018 report and accounts, many of which will be published shortly ahead of the March deadline for the UKs departure from the EU.

Look to provide disclosure which distinguishes between the specific challenges to the business model and the broader economic uncertainties. Where there are particular threats, for example the possible effect of changes in import/export taxes or delays to their supply chain, these should be clearly identified along with any actions taken (or planned) to manage the potential impact. This may mean recognising or re-measuring certain items in the balance sheet.

Given the broad uncertainties, ensure sufficient information is disclosed to help users understand the degree of sensitivity of assets and liabilities to changes in management's assumptions. Consider the wide range of reasonably possible outcomes when performing sensitivity analysis on the cash flow projections and which should be disclosed and explained – and which, if any, have an impact on the viability statement and even the ability to continue as a going concern.

Be cognisant of any changes between the balance sheet date and the date of signing the accounts, and ensure a comprehensive post balance sheet events review is factored into the year-end reporting plan in order to identify both adjusting and non-adjusting events and to make the necessary disclosures.

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