Quarterly 21

Audit Committee Toolkit Belgium released
A good board has good social dynamics
Global boardroom insights:
Audit committee top challenges
COSO releases internal control – integrated framework (2013)
Is internal audit properly focused and fully utilized?
The future of corporate reporting:
Towards a common vision

Resources
About the Audit Committee Institute

The Audit Committee Institute (ACI) was created to assist audit committee members adapt to their evolving roles. Sponsored by KPMG, the ACI is a shared-knowledge and informational resource recognizing the audit committee’s pertinence and importance to organizations.
Audit Committee Toolkit Belgium released 6
A good board has good social dynamics 8
Global boardroom insights: Audit committee top challenges 14
COSO releases internal control – integrated framework (2013) 18
Is internal audit properly focused and fully utilized? 22
The future of corporate reporting: Towards a common vision 26
Resources 30

For more information on the work of the ACI, please utilize our Website: www.audit-committee-institute.be

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Audit Committee Institute in Belgium
Welcome to the latest edition of Audit Committee Quarterly, the publication designed to help keep audit committee members abreast of regulatory matters, company law, issues in accounting and audit and changes in the corporate governance arena.
Being particularly pleased with the release of our newly produced Audit Committee Toolkit BELGIUM, we kick-off this edition of the Audit Committee Institute Quarterly introducing this pertinent audit committee vade mecum.

Next in this issue, we cover an interview with INSEAD professors Timothy Rowley and Ludo Van der Heyden. We read of their views on the social dynamics of a board determined by independence, diversity of thinking, real involvement and willingness to learn.

Further, we present the views of four audit committee chairs from significant global organizations on key challenges and priorities shaping the audit committee and board agendas.

The recently released COSO 2013 internal control - integrated framework is examined next, focusing on the key changes versus the 1992 framework and pointing to specific considerations for audit committees.

In response to the results on internal audit added value from recent global ACI surveys, we touch on the question: “Is internal audit properly focused and fully utilized?” In this respect, we also zoom in on some guidelines for directors.

With the growing consensus that current corporate reporting needs to be improved, we aim to encourage the debate on the future of corporate reporting, bringing together the views of 10 leaders in this field.

We end this edition with our Audit Committee Resources series.

We hope this publication serves its intended purpose of briefing you on the important developments affecting your role as an audit committee member.

If you require further information, please contact us at info@auditcommitteeinstitute.be with any comments or suggestions of topics you would like to see receive attention.

Our ACI website (www.auditcommitteeinstitute.be) also provides additional information, including our Audit Committee Toolkit BELGIUM and previous editions of the Audit Committee Institute Quarterly and other useful publications, surveys and knowledge samples.

We trust you are continuing to enjoy the benefits of ACI membership.
Corporate governance excellence continues to be an important element of business, both in Belgium and across the globe. Expectations of stakeholders have never been higher, and the scrutiny by regulators and investors never more stringent. As a consequence, the role of the audit committee has rapidly increased in importance and expanded in scope.
In today’s complex and evolving business environment, audit committees can make a strong contribution to a ‘no surprises’ environment and an effective audit committee can be a key feature of a strong corporate governance culture, bringing significant benefits to an organisation. Such committees are supported by fundamental building blocks: an appropriate structure and foundation; reasonable and well defined responsibilities; an understanding of current and emerging issues; and a proactive, risk-based approach to its work. Carefully designed practices can also help an audit committee to maximise its contribution to an organisation.

In this context, ACI is pleased to announce the release of the newly produced Audit Committee Toolkit BELGIUM on 12 December 2013. We believe our toolkit is unique and relevant for all directors as it articulates, from a specific Belgian perspective, the principles underlying the audit committee’s role while also providing a vast amount of non-prescriptive guidance to help audit committees and boards gain a better understanding of the processes and practices that help create and sustain effective audit committees.

Our Audit Committee Toolkit BELGIUM kicks-off with five guiding principles for audit committees ACI believes underlie the effectiveness of every audit committee, while also recognizing that one size does not fit all.

The Belgian regulatory landscape related to audit committees is summarized in a comprehensive overview for easy reference.

The toolkit further discusses various relevant considerations on the composition of the audit committee and the procedures and practices that provide the support and structure necessary to discharge an audit committee’s duties to the board.

More detailed separate chapters are added focussing on the respective duties of the audit committee and related ACI best practices: monitoring the corporate reporting process; monitoring the effectiveness of internal control and risk management systems; monitoring the effectiveness of internal audit and external audit; and communication with shareholders.

At the back of our toolkit are a complete set of appendices that are intended to provide practical support to audit committees.

For example these appendices include inter alia:

- Example audit committee terms of reference
- Audit committee self assessment checklist
- Example risk summary and register
- Evaluation of the internal and external audit checklists
- Practice aid on how to conduct an audit tender
- Audit committee disclosure checklist

We hope this publication provides practical guidance to help audit committees to identify and achieve their objectives and add value to the board, the organisation and its stakeholders.

Special thanks to our reading panel

We owe a debt of gratitude to the reading panel of ACI members for taking the time to review the draft version of our toolkit:

- Lutgart Van den Berghe
  Guberna: Executive Director
- Franky Depickere
  KBC Group: Chairman of the Audit, Risk & Compliance Committee
  Remuneration & Nomination Committee Institute: Chairman
- Theo Erauw
  Audit Committee Institute: Honorary Chairman

Get your copy of ACI’s Audit Committee Toolkit BELGIUM …

As from 12 December 2013, you can download the softcopy version of the Audit Committee Toolkit BELGIUM, together with editable versions of most of the appendices from our website at www.auditcommitteeinstitute.be.

However, we rather hope to welcome you to one of our future events to be able to provide you with the opportunity to receive your personal hardcopy of ACI’s Audit Committee Toolkit BELGIUM free of charge.

“We believe our toolkit is unique and relevant for all directors”
“A good board has good social dynamics”

For the functioning of a board, the interaction among the board members is crucial for the effectiveness of the board. Independence and diversity of thinking, real involvement and willingness to learn determine the social dynamics of a board, say INSEAD professors Timothy Rowley and Ludo Van der Heyden. On the campus of INSEAD, ACI spoke with the two directors of the International Directors Programme: “Board effectiveness is about social interaction and trust. It is not structure of governance, it is human relations.”
The INSEAD Corporate Governance Initiative in Fontainebleau, led by professor Ludo Van der Heyden, is a platform for debate, research and teaching on corporate governance.

Its International Directors Programme (IDP), launched in 2011, is aimed at current board members and senior executives preparing themselves for a board mandate. Professor Van der Heyden and visiting professor Timothy Rowley from the University of Toronto also spoke about board dynamics. In the IDP, which consists of three modules of three days, the interaction within the board and with management occupies a major part. Ludo Van der Heyden defines board dynamics and its relation with board effectiveness as: “the interaction between the board members and its effects on board effectiveness”.

He believes this effect is direct, so board dynamics is essential for board effectiveness. Tim Rowley adds: “If you have a board with really good people, a good chair and a very solid information exchange, but it lacks good social dynamics, it’s like having a car without tyres. It will not work, even if the machinery is perfect. If you cannot work with the CEO and as a team with the other members, there will be no results.”

So laws, rules, codification and other formalities that give structure to corporate governance, will not produce results unless a board has good social dynamics?

Rowley: “It is the quality of interaction and trust. Structure in governance is second, quality of human relations is first. An anthropologist would say that people need trust in order to work together, just like we need oxygen to breathe. You need to feel that you are being looked after, and that people do not take advantage of you. Further, you trust the other is of good will and that he is capable of doing what he says he will do. These things break down a lot amongst board members and especially between the board and the CEO; when these lack either the goodwill or the trust in each other’s capabilities, board dialogue is hampered. And when dialogue is lacking, it influences the whole board dynamics. Imagine the situation when a great board with great social dynamics has a majority shareholder who has a shareholder agreement that says that, at the end of the day, they get to decide everything and they indeed pull that agreement out of their back pocket at a certain point. Then the whole social dynamics of the board are destroyed.”

I can imagine social dynamics in boards is a major topic in your studies and classes.

Van der Heyden: “Absolutely. Today for instance we had a class about the tools for board dynamics called fair process leadership, which is about how to engage as a board member. If you engage well, if you are a ‘fair process leader’, you will be creating trust. In companies people say: what is the value of our stock? But with trust it’s the same thing: how high is our stock of trust? Trust is a capital good. How trust is created is very interesting. We know from sports that trust grows between people who have gone through rough times together. To have substantial trust in you, I will have to see what you did

“The quality of the discussion is really a good measure of the quality of the chair”
when I was down, or vulnerable. That is part of the CEO-board issue. The CEO looks at how the board reacted when he was down, when he was not delivering and was vulnerable. Did they blame him, did they support him, did they take some of the blame for some of the mistakes, because they were responsible as well?"

*How do you see the role of the chair in this process of preventing the erosion of trust?*

**Rowley:** "The chair plays several roles, but in my view the most important role is to facilitate the discussion. So the quality of the discussion is really a good measure of the quality of the chair. Maximizing the contribution of each individual and making sure that the team is better than the sum of the individuals. That is a very difficult task. The board time has to be used efficiently. A board member is worth 5,000 or 10,000 Euros a day. And you have ten people in the room, what is ten minutes worth? Maximizing that value is the task of the chair. One third of our nine day programme is devoted to social dynamic issues. But on every day of the programme there are at least two break-out sessions in which people act like the board members they are. So also the coffee breaks consist mostly of board dynamics. And then we play a few board simulations."

*What do you see in those simulations?*

**Rowley:** "In the very first session most of them come out and try to show their ego. They show what they know and who they are. The peacock is showing its feathers. People are not listening but are telling a lot, asking few questions of others. Over time they start learning their role, where they fit into the group and they start looking where they can add value. This is also the process you see in actual boards. People learn to speak out only when they can contribute something."

**Van der Heyden:** "In board dynamics the emotional intelligence, the EQ is very important. EQ is viral, IQ is not. A peacock that will not learn to fold his feathers can destroy the whole team. And that’s where the role of the chair is very important. But you cannot put it all on the shoulders of the chair. In the programme we spend a whole day on the difference between group decision making and individual decision making. Group intelligence is not necessarily the sum of the individual intelligences. And bad social dynamics in the group can destroy the group decision making process and reduce the intelligence of the group. The chair indeed plays a crucial role in this. He has to manage the discussion and that’s also a matter of efficiency.

How can boards deal with the effects of confirmation bias, the tendency of people to favour information that confirms their beliefs or hypotheses?"

**Rowley:** "Confirmation bias and stereotyping are forms of shortcuts that can easily lead to poor decision making. What is happening a lot in boards is that pushing for efficiency comes at the cost of effectiveness, missing important elements for good decision making. So, the second most important task of the chair, after inspiring trust and good social dynamics, is to make sure that the drive for efficiency does not diminish effectiveness. The third challenge is what I call the ‘bad director’. It always amazes me how people who are clearly not capable, who are unprepared, who damage the social dynamics of the board, last for years because nothing is done about it. Some of them may act more like a manager than a board member. Or their skills do not match the required skills anymore because the company has changed. Boards avoid addressing the issue of the obsolete director and go out of their way not to have the tough conversation saying you have to. They try to solve it by creating an age limit, of seventy for instance, but then a great director may have to go because you try to get rid of somebody else! That is terrible for board effectiveness and for social dynamics."

“It takes a generous and self-confident CEO to assert that his successor is really good”
Van der Heyden: “And the toxic people are often the ex-CEO’s, who get a non-executive board position in their company as a natural reward of having been a great manager (of course it is even worse, when the CEO is “moved upstairs”). It takes a generous and self-confident CEO to assert that his successor is really good. So the former CEO can really affect board dynamics, positively or negatively. As we say he or she anchors the board one way or the other.”

It is difficult for non-executives to both support and challenge the executives, depending on the situation. You often see they start supporting and later when there are problems they suddenly begin to challenge. How can a board strike the right balance?

Van der Heyden: “I think the board has to organise contrary views. So when an acquisition is being contemplated and the advantages are being mentioned, one or two members have to take the other view. But that should not always be the same people. You must be able to shift roles and switch positions.

When one person is always the one who sees the downside, after a while people tend to ignore that person.”

Rowley: “It is natural to support in good times and challenge in bad times. But what the chair needs to do is just the opposite. He should challenge the CEO when the going is good and be supportive in bad times. In the latter situation the chair has to take the responsibility that he was the one who chose the CEO and it’s your job to see him or her through.”

It is trendy nowadays to talk about board leadership, meaning that the non-executives should assume a more proactive role in managing the decision making process. How do you see that?

Rowley: “I think that is a question of time commitment and of being involved. Leaders are people who are involved. That is difficult and has to do with several factors, but a major factor is emotional commitment, but also time commitment. So when you pick new board members, make sure that the person has enough time.”

Van der Heyden: “I would like to add that leading is undistinguishable from following. Good leaders also take time to listen and to follow others; they take the lead maybe only ten percent of the time. So I would say boards need more leadership, but maybe less from each person as a percentage of time. We need leaders who know when to lead and when to be led.”

“More diversity means also more discipline. When you just create more diversity without discipline you end up with the Tower of Babel”
Do you think a compliance driven form of oversight, caused by the increase of external regulation, influences the discussion and maybe makes it less open?

Rowley: “Certainly, especially with respect to audit, which is very much compliance driven, consuming more and more of the audit committee’s and board’s time. Most of it is inevitable, so the best thing is to move as much as possible to the audit committee, so that the full board has more time for open discussion. Demands on audit committee members are so high today, I think they will have to spend more time and be paid more. I know audit committee members who have no time to sit on another board because of the time they have to spend on the audit committee.”

Van der Heyden: “Regulation in general has put more work on the different board committees, which gives the full board more of a coordinating role. It makes taking responsibility by the full board more difficult because people have to understand the things coming out of these committees and commit to them. I see this as a kind of implosion of the board by outsourcing the work to board committees. It is an issue to be considered.”

Diversity is also a hot issue. How do you see the relation between diversity and board effectiveness?

Van der Heyden: “More diversity means also more discipline. When you just create more diversity without discipline you end up with the Tower of Babel. By and large the issue is: don’t have diversity that you cannot manage. When you think you need a Chinese person at the table you must know how to get the best out of this Chinese director. Otherwise it doesn’t help the board; it only takes more time and awkwardness.”

Rowley: “At the end of the day diversity is meant for one thing: to have different views and more informed decisions. There are all kinds of proxies to increase diversity. We tend to take things we can see: different ages, different cultures, gender of course. But diversity of view can exist between people who look alike a lot. Diversity is a valuable asset for a board, if you have good social dynamics. If you don’t – and I put most of this on the chair – diversity can actually be harmful. And more diversity invariably challenges board dynamics.”
Many supervisory board members feel uneasy having to rely completely on management for their information. What is your view?

**Van der Heyden:** “There is no monopoly on information, so I encourage people to go around the company to talk to people. It can be done on site visits but also talking with customers and other stakeholders. Of course you should always inform management when you do so. I advocate the ‘Colombo way’, the detective who sniffs around, talks to people asking stupid questions, never really telling much, always trying to gain greater understanding. They talk about management by walking around, but I think you also have to govern by walking around. Management may feel uneasy when non-executives speak with stakeholders, but at the end it creates a better team spirit between the board and the managers when everybody feels and knows that they understand what’s going on in the company.”

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**Who is Who ...**

**Timothy Rowley**
is visiting professor at INSEAD and academic director of the International Directors Programme; professor of strategy and organizations at the University of Toronto; director of the Clarkson Centre for board effectiveness at the Rotman School of Management, University of Toronto.

**Ludo Van der Heyden**
is the Mubadala chaired professor in corporate governance and strategy; academic director of the INSEAD Corporate Governance Initiative. He has been a senior director of a family company and is a board member of several start-up companies.
Global boardroom insights:
Audit committee top challenges

In a new series of global publications from the Audit Committee Institute, we bring together the views of audit committee chairs from significant global organisations on key challenges and priorities shaping audit committee and board agendas. Seasoned directors share their insights on a range of issues, including lessons learned from the past several years; keys to maintaining strong audit committee/auditor communications; how the speed of change in technology and an increasingly complex risk environment are impacting the audit committee and board agenda and more.
A seasoned audit committee chair recently remarked that every new director should spend time on the audit committee, as it “provides such a rich and comprehensive view of the business and the challenges and risks facing the company.” Indeed, audit committees have a unique vantage point.

In their vital oversight role – ensuring financial reporting integrity and audit quality, often overseeing legal/regulatory compliance, IT and cyber security and other key risks, as well as the risk management process – audit committees offer a valuable perspective on the company’s performance and the critical challenges and risks ahead.

Clearly, no one size fits all. The directors’ views are shaped by a number of factors – not least, the unique economic, regulatory, and political environments in the countries in which their companies operate. Nevertheless, common themes emerged – including the sharp focus on corporate reporting, accounting and financial control; assessing risk oversight and the role played by the audit committee and staying focused on regulatory challenges on a global level.

**ACI: What are the two or three top current issues that you see as being particularly challenging for audit committees?**

**UK – Mr. Land:** “I’m not sure the priorities have changed dramatically over the last year, but we are certainly seeing a migration beyond the financial sector towards audit and risk committees in the UK and in any event many audit committee remits are continuing to widen whether or not the formal transition to take on the oversight of risk is made.

Audit committees are also under greater scrutiny than before and that scrutiny is increasing. Audit committees might not yet receive the same shareholder, media, and political attention as remuneration committees – the shareholder spring really focused minds in that area – but the aftershock of the financial crisis and the general economic uncertainty means that the spotlight is being focused once again on the audit committee.

Risk continues to be high on the audit committee agenda – in particular, reputational risk. For many of the corporate crises we’ve witnessed over the past few years, the first impact has been on corporate reputation, with consequences around growth, profitability, brand, etc.

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**Who is Who ...**

**UK perspective – Mr. Nick Land,** a chartered accountant, retired as chairman of Ernst & Young LLP in 2006 after a career spanning 36 years with the firm. He is now a non-executive director and chairman of the audit and risk committees of Vodafone Group plc, Alliance Boots GmbH, BBA Aviation plc and the Ashmore Group plc. He is also the senior independent director for BBA Aviation plc and Ashmore Group plc. Mr. Land also sits as a non-executive director on the UK’s Financial Reporting Council – the UK’s independent regulator responsible for promoting high quality corporate governance – and chairs the Audit and Assurance Council.

**Brazil perspective – Mr. Celso Clemente Giacometti** is chairman of Banco Santander Brasil, where he is also a member of the audit, compensation and nomination committees. Mr. Giacometti also serves as president of the Fiscal Council and audit committee at Ambev. He is co-founder of the Brazilian Institute for Corporate Governance and a member of its board and was president of Arthur Andersen in Brazil until 2001.

**Germany perspective - Dr. Bernd Voss** is chairman of the audit committee at Continental AG. Dr. Voss started his professional career in 1958 with Dresdner Bank AG, which later merged with Commerzbank AG. He served on the board of managing directors of Dresdner Bank AG from 1988 to 2001 and has served on a number of supervisory boards.

**US perspective – Mr. Michael Mancuso** serves on the boards The Shaw Group and SPX Corporation and chairs the audit committees of both boards. Mr. Mancuso retired in 2012 as corporate vice president and CFO of CSC. He previously served as senior vice president and CFO of General Dynamics Corporation; as vice president and CFO of the commercial jet engine business at Pratt & Whitney Group, United Technologies Corporation and in various senior financial management positions with the General Electric Company.
As the current recession continues – whether it is technically a recession or not doesn’t really matter – we might well see some companies running into “going concern” problems and refinancing issues. So far UK companies have seen few corporate casualties during the downturn. Many companies had to refinance in 2008/2009 and managed to do so pretty successfully, but as the global economy continues to be fragile and the Euro crisis remains unresolved, refinancing might well move to the top of the list.

Effective company stewardship is also an issue, and in the UK audit committees and boards are starting to think about the recent changes to the UK Corporate Governance Code. The new disclosures relating to “fair, balanced and understandable” annual reports, the significant financial reporting matters considered by audit committees and the appointment of auditors will not directly impact many companies, but I think we will see companies starting to get ahead of the game whether or not they go the whole way. This will undoubtedly raise some issues around clarity. Do we really understand what fair, balanced and understandable means? How are we going to define it? How much detail? ”

Brazil – Mr. Giacometti: “Clearly, there will still be economic challenges, with a considerably lower interest rate than we have been used to as of the the results. The pressure on companies’ cash flow, the higher speed of inventory prices and the need for possible higher accruals for pension and other employee obligations under updated actuarial calculations are some of the relevant impacts resulting from this new scenario. Add to that the uncertainty about GDP growth that can result in under-delivery by companies. These factors may pose a higher risk related to financial management, since there is an inclination to an aggressive use of financial instruments and the use of more creative accounting practices. Audit committees should be particularly alert to these financial reporting risks and should also play a more prospective role, looking closely to present and future cash flows.

We should also focus on internal controls. In difficult times, companies tend to reduce costs and investments – employee head counts, professional development, technology and others – which might weaken internal controls. It’s also important to consider re-adapting the role of internal audit for the new environment, as monitoring should be even stricter considering the higher temptation to use creative solutions.

Issues related to environmental risks, licenses, and authorizations should also be prominent on the audit committee’s agenda. Many companies need licenses for installation, operation, and other kinds of authorizations, and this issue is often not reviewed by the committee, as a matter of routine. The same is true for environmental risks that might create significant problems for companies – lawsuits, fines or damages to the company’s image and brand."

Germany – Dr. Voss: “At the top of my list is digitization, cyber attacks and IT risks. Although no successful attack has been launched so far, the threat of cyber attacks has significantly increased over the last few years, particularly risks related to protection of IP and non-financial information, as well as risks to the reputation of the company. We’re very focused on maintaining a high level of awareness of such risks at the employee level.

Auditor communications and reporting are also key areas of ongoing focus. We have already set very clear expectations as to audit quality and the auditor’s reporting in the audit committee meeting in terms of demanding transparency, quality reporting, two-way communication and a focus on the relevance and materiality of the information. All of these elements are essential to support the audit committee in carrying out its oversight responsibilities. As such, this priority is unchanged.

Tax risk is another top issue. Oversight of tax risks resulting from globalization and the complexity of operating in different tax regimes is increasingly important – particularly as a reputational risk. Recent cases with significant coverage in the media have raised the awareness of the reputational risks because of aggressive tax planning strategies.”

US – Mr. Mancuso: “I think the main challenge for boards is to continue to be diligent in assessing business risk, whether it’s new product development, acquisitions, global expansion or new markets. The primary thing pressing on boards is to protect shareholder returns, which means being able to fully assess a business decision and the associated risks.

Besides the business risk issues, another big challenge for all boards is the evolving regulatory environment. The potential downside of not complying satisfactorily with current regulations or new ones as they’re promulgated can be significant – whether it’s Dodd-Frank or updates to Sarbanes-Oxley or new revenue recognition accounting standards from the FASB.

Accounting standards continue to change and evolve, and directors need to stay reasonably abreast of what those standards mean and how they are applied, which
isn’t easy. Accounting standards are already difficult to understand. The terminology and the application can get very esoteric. Perhaps with the exception of the financial expert who sits on the audit committee, the average director’s eyes glaze over when the discussion is about the application of an accounting standard or whether or not a disclosure is fulsome enough to satisfy the regulators, and how much disclosure is really needed.

Compliance and staying abreast of the evolving regulatory environment will be an ongoing challenge.”

ACI: Are there any “lessons learnt” from the last two or three years that would be worth sharing with other audit committee members?

UK – Mr. Land: “I think there were lessons learnt by those companies that had to go through refinancing at the height of the financial crisis. Even though most companies seem to have done it pretty successfully – albeit at a price – I imagine that it made management, boards, and audit committees reflect a little bit more or re-reflect on their financing strategies.

The other thing is that the audit committees and auditors are once more under the spotlight and the calls for increased transparency from the audit committee around why they’re reappointing auditors is just one aspect of this. We’ve also got regular audit retendering in the UK by virtue of the FRC’s Corporate Governance Code and a reasonable possibility of mandatory rotation coming down the line from Brussels.

I think one of the things that audit committees are starting to reflect on – and I’ve been worried about this for a couple of years– are the difficulties audit committees have in measuring audit quality. Audit service is pretty easy to measure and of course that’s related to quality. A “no surprises” environment; good communication; sector knowledge; and of course the chemistry with the lead team that the audit committee sees is absolutely crucial. But whether they’re actually doing a good audit or not is a bit more difficult. Are they really hitting revenue recognition as hard as they should be? Are they really using the latest data analytic techniques – which most audit committee members and directors are only beginning to probe and understand? I think this is increasingly an issue and audit committees are beginning to ask questions and articulate their thinking.”

Brazil – Mr. Giacometti: “The first would be to focus on the improvement of communication and reporting of activities of the audit committee to the board of directors. Today, there is a gap in this communication, partly due to the fact that boards often have such confidence and trust in the work of the committee that they don’t always undertake their supervisory role in a robust way. This also happens because, depending on the board’s composition, not all members understand financial reports and accounting practices deeply enough to evaluate them and end up relying on the committee’s recommendations.

Another important consideration is management’s representation regarding financial information presented to the committee and the board. It must be clear that the responsibility for financial reporting and the preparation of financial statements is a management responsibility.”

Germany – Dr. Voss: “I would stress the importance of the external auditor’s role in supporting the audit committee. A high level of reliability, based on performance against clearly-defined expectations, meaningful and close communication, as well as delivering a high level of audit quality is essential. The audit committee requests frequent, early and quality communication from the external auditor, including very open discussion – whether it’s about significant estimates and judgment, or key risks facing the company.”

US – Mr. Mancuso: “Boards are more involved than ever, as they should be – a lot is being expected of directors today. But it’s important to remember that the board is there to oversee management, not to manage the company. I think those lines are starting to blur, and it’s incumbent upon boards to completely understand where that line of demarcation should be drawn and what their roles and responsibilities are.”

**The 17 principles**
The changes made to update the 1992 Framework are evolutionary, not revolutionary. In short, the 2013 update provides clarity for understanding the requirements of effective internal control to facilitate the design and implementation and assessment of an internal control system. Additionally, the 2013 Framework broadens its application by expanding the operations and reporting objectives.

The 2013 Framework retains the definition of internal control and the COSO cube, including the five components of internal control: Control Environment, Risk Assessment, Control Activities, Information and Communication and Monitoring Activities.

The most significant change made in the 2013 Framework is the codification of the 17 principles that support the five components. The 17 principles were fundamental concepts implicit in the 1992 Framework. For effective internal controls, the 2013 Framework requires that (1) each of the five components and the 17 relevant principles be present and functioning; and (2) the five components must operate together in an integrated manner.

An effective internal control system requires that components operate together, and all components are present and functioning and internal control deficiencies aggregated across components do not result in one or more major deficiencies. A major deficiency represents an internal control deficiency or combination thereof that severely reduces the likelihood that an entity can achieve its objectives.

The 2013 Framework also provides example characteristics for each of the 17 principles, called “points of focus”. They assist management in determining whether a principle is present and functioning. The judgment required by management, the board of directors, audit committees and other personnel to design, implement and conduct the
internal controls and assess their effectiveness has not changed.

Definition of internal control and objectives

Internal control is defined in the 2013 Framework as “a process, affected by an entity’s board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives relating to operations, reporting, and compliance.”

The COSO Framework is designed to be used by organizations to assess the effectiveness of the system of internal control to achieve objectives as determined by management. The 2013 Framework lists three categories of objectives, similar to the 1992 Framework:

1. Operations Objectives – related to the effectiveness and efficiency of the entity’s operations, including operational and financial performance goals and safeguarding assets against loss. In the 1992 Framework, the operations objective was limited to “effective and efficient use of the entity’s resources.”

2. Reporting Objectives – related to internal and external financial and nonfinancial reporting to stakeholders, which would encompass reliability, timeliness, transparency or other terms as established by regulators, standard setters or the entity’s policies. In the 1992 Framework, the reporting objective was called the financial reporting objective and it was described as “relating to the preparation of reliable financial statements.”

3. Compliance Objectives – related to adhering to laws and regulations that the entity must follow. In the 1992 Framework, the compliance objective was described as “relating to the entity’s compliance with applicable laws and regulations.”

The seven factors in the 1992 Framework relating to an effective control environment are integrity and ethical values; commitment to competence; board of directors or audit committee; management’s philosophy and operating style; organizational structure; assignment of authority and responsibility; and human resource policies are captured in the five principles relating to Control Environment in the 2013 Framework.

Components

The five components of internal control are the same in both the 1992 and 2013 Frameworks; however, the 1992 definitions have been expanded in the 2013 Framework to address changes in markets, governance concepts, business models, laws and regulations, information systems, etc.

The control environment

“The control environment is the set of standards, processes, and structures that provide the basis for carrying out internal control across the organization. The board of directors and senior management establish the tone at the top regarding the importance of internal control and expected standards of conduct.”
Control environment principles:

1. The organization demonstrates a commitment to integrity and ethical values.
2. The board of directors demonstrates independence from management and exercises oversight of the development and performance of internal control.
3. Management establishes, with board oversight, structures, reporting lines and appropriate authorities and responsibilities in the pursuit of objectives.
4. The organization demonstrates a commitment to attract, develop and retain competent individuals in alignment with objectives.
5. The organization holds individuals accountable for their internal control responsibilities in the pursuit of objectives.

The 2013 Framework links the various components of internal control and demonstrates that the control environment is the foundation for a sound system of internal control.

Risk assessment principles:

1. The organization specifies objectives with sufficient clarity to enable the identification and assessment of risks relating to objectives.
2. The organization identifies risks to the achievement of its objectives across the entity and analyzes risks as a basis for determining how the risks should be managed.
3. The organization considers the potential for fraud in assessing risks to the achievement of objectives.
4. The organization identifies and assesses changes that could significantly impact the system of internal control.

Risk assessment

“Risk assessment involves a dynamic and iterative process for identifying and analyzing risks to achieving the entity’s objectives, forming a basis for determining how risks should be managed. Management considers possible changes in the external environment and within its own business model that may impede its ability to achieve its objectives.”

Control activities

The 1992 Framework focused on three areas: management’s process for objective setting at an entity-wide and activity level; risk analysis and managing change. The 2013 Framework recognizes that many organizations are taking a risk-based approach to internal control and that Risk Assessment includes processes for risk identification, risk analysis and risk response; that risk tolerances and an acceptable level of variation in performance should be considered in the assessment of acceptable risk levels and the discussion of risk severity includes velocity and persistence in addition to impact and likelihood. Most significantly, the Risk Assessment component now includes a separate principle to address the risk of fraud in the organization.

Control activities principles:

1. The organization selects and develops control activities that contribute to the mitigation of risks to the achievement of objectives to acceptable levels.
2. The organization selects and develops general control activities over technology to support the achievement of objectives.
3. The organization deploys control activities through policies that establish what is expected and in procedures that put policies into action.

Information & communication

“Information is necessary for the entity to carry out internal control responsibilities in support of achievement of its objectives. Communication occurs both internally and externally and provides the organization with the information needed to carry out day-to-day internal control activities. Communication enables personnel to understand internal control responsibilities and their importance to the achievement of objectives.”

The importance of having the right information communicated to managers at the right time has become a key to successful business operations and effective internal control as organizations have become more complex in their structure and global operations and more dependent on technology.
**Information & communication principles:**

1. The organization obtains or generates and uses relevant, quality information to support the functioning of internal control.

2. The organization internally communicates information, including objectives and responsibilities for internal control, necessary to support the functioning of internal control.

3. The organization communicates with external parties about matters affecting the functioning of internal control.

**Monitoring activities principles:**

1. The organization selects, develops, and performs ongoing and/or separate evaluations to ascertain whether the components of internal control are present and functioning.

2. The organization evaluates and communicates internal control deficiencies in a timely manner to those parties responsible for taking corrective action, including senior management and the board of directors, as appropriate.

**Limitations of Internal Control**

The 2013 Framework acknowledges that there are limitations related to a system of internal control. In designing, implementing, and conducting an effective system of internal control, management recognizes the system’s inherent limitations and addresses ways to minimize these risks. However, an effectively designed system will not eliminate these risks. An effective system of internal control provides reasonable assurance, not absolute assurance, that the organization will achieve its defined operating, reporting and compliance objectives.

**Documentation**

The 2013 Framework points out that effective documentation of the organization’s system of internal control is necessary to provide evidence of its effectiveness and to enable proper monitoring. Effective documentation of internal control is also useful for assigning responsibility and accountability to employees; training new and experienced employees who implement and monitor the controls; promoting consistency across the organization and retaining organizational knowledge.

**Considerations for audit committees**

- Get acquainted with the changes and related language of the 2013 Framework.
- Check whether management has instituted a preliminary impact assessment to check whether the relevant principles of the 2013 Framework are in place and functioning according the organization’s objectives.
- Inquire into management’s efforts to facilitate awareness, training and a more comprehensive assessment for all staff concerned.
- Verify and question management whether a process is in place to identify, assess and implement necessary changes in controls.
- Discuss with management regarding its plan to adopt the updated framework.
- Review the existing internal audit plans in view of the updated framework.
The past few years have been a dynamic period for internal audit, with a significant shift taking place in the mandate for internal auditors: For many internal audit organizations, the focus is no longer limited to financial reporting and compliance risks. It now includes key business risks and related controls – from cyber security and IT, to key strategic and operational processes. Yet, according to a recent survey by the Institute of Internal Auditors, for many—or perhaps most—internal audit organizations, audit coverage still lags in two key risk areas: business and strategic risks, and the overall effectiveness of the company’s risk management processes.

In our own ACI global surveys, audit committees consistently point to the need for internal audit to “deliver greater value” to the organization:

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**Audit committee internal audit function added value satisfaction:**

- Satisfied: 45%
- Somewhat satisfied: 34%
- Not satisfied: 14%
- Company does not have an internal audit function: 7%

Source: ACI Global Survey January 2013

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**Audit committee internal audit critical risk focus satisfaction:**

- Satisfied: 45%
- Somewhat satisfied: 31%
- Not satisfied: 14%
- Company does not have an internal audit function: 6%

Source: ACI Global Survey January 2013

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**Is Internal Audit Properly Focused and Fully Utilized?**
How can audit committees help ensure that internal audit is properly focused and fully utilized—and delivers the value it should? We offer the following suggestions.

**Consider the need to re-define internal audit’s mandate**

Internal audit is most effective when it is focused on the critical risks to the business, including key strategic and operational risks and related controls—not just compliance and financial reporting risks. Internal audit should constantly monitor how changes in the operating environment impact the business. In today’s global, digitized environment, a broad range of critical risks need to be managed—from cyber security and social media, to risks posed by market expansion, M&A and the global supply chain to talent management and culture—and internal audit should be assessing these risks and associated controls. Leading internal audit functions are also reviewing the company’s overall risk management processes and working with management to continuously improve these processes. We’re even seeing internal audit being asked to take the lead in coordinating with other governance, risk, and compliance functions within the organization to identify duplication—and, more importantly, potential gaps—in coverage.

How involved can or should internal audit be in these areas while maintaining the requisite focus on financial reporting and internal controls? To answer this question, and to get the most value from internal audit, the audit committee should work with management to determine the right balance of coverage. Competing expectations of the audit committee, CEO, CFO, business unit leaders, risk and IT
officers and others may, without proper planning, pose significant risks: internal audit may lose focus, the quality of its work may suffer and its resource and skill-set requirements may be poorly defined. To minimize these risks it is critical to have clear, companywide agreement on internal audit’s mandate.

Make sure internal audit has the right resources and skill sets
With an increased focus on the company’s key strategic and operational risks, internal audit may need to acquire new skills—e.g. in IT, risk management, operational knowledge (supply chain, shared services, outsourcing), continuous auditing, data analytics, strategic planning and more—by training, hiring new talent or sourcing from outside service providers. Of course, the audit committee should continue to ensure the adequacy of internal audit’s resources and skills in the assessment of compliance and financial reporting risks and controls.

Reinforce internal audit’s objectivity and independence and its accountability to the audit committee
As internal audit becomes more involved in helping the organization manage critical strategic and business risks and improve risk management processes, there is a greater need for the audit committee to help ensure internal audit’s “objectivity”. A direct, open line of communication between the audit committee and the chief internal audit executive becomes even more important, and here the audit committee chair plays the key role.

Internal audit should be moving towards a higher value-add model and functioning as an increasingly valuable resource—a trusted adviser and consultant—to the audit committee. However, this likely will not occur without the backing and support of the audit committee for internal audit to expand its mandate—with the right focus, resources and independent perspective.
In 2013, the Institute of Internal Auditors (IIA) issued 10 guidelines for boards to ensure that their organisations maximise the value of internal audit and gain the most protection and assurance from its activities.

### What every director should know about internal audit – Guidance from the Institute of Internal Auditors

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<td>1</td>
<td>Evaluate the need for internal audit, where it does not exist.</td>
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<td>2</td>
<td>Assess and approve the internal audit charter (terms of reference) and review regularly.</td>
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<td>3</td>
<td>Ensure a close working relationship with the head of internal audit, promoting effective formal and informal communication.</td>
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<td>4</td>
<td>Assess the resourcing of the internal audit function.</td>
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<td>5</td>
<td>Monitor the quality of internal audit work, both in-house and external.</td>
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<td>6</td>
<td>Evaluate, approve and regularly review the risk-based annual internal audit plan.</td>
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<td>7</td>
<td>Oversee the relationship between internal audit and centralised risk monitoring.</td>
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<td>8</td>
<td>Ensure the collective assurance roles of internal audit, other internal assurance providers and external audit are coordinated and optimised.</td>
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<td>9</td>
<td>Assess internal audit findings and the breadth and depth of internal audit reports.</td>
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<td>10</td>
<td>Monitor management implementation of internal audit recommendations.</td>
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The KPMG report “The future of corporate: towards a common vision” aims to encourage a debate regarding the future of corporate reporting, beginning with the premise that the current reporting model needs to be improved.

It is a matter of debate as to how – and how far – it should change. The report is based on interviews with 10 leaders (see box) in the field of corporate reporting and represents a cross-section of opinion. All of them believe that changes to the reporting model are needed, but they hold widely differing views on exactly what needs to be altered and how.

As the world economy slowly recovers, it is time to consider where corporate reporting goes next. One of the lessons from the crisis is that we lacked insight into the risks that were building up, both in the system and among companies. How can we delve deeply into the health of the private sector if our corporate reporting standards and practices are not up to the job?

Admittedly, there were already warning signs to be found in corporate financial statements prior to 2008, if people had looked hard enough. And as we peer into the future, we must not think that corporate reporting is a magic elixir; companies and their executives need to be held accountable for taking excessive risks. But the fact is that even if there had not been a financial crisis, we would need to consider changing the current reporting model.

The need to raise the bar
So what is the debate about? The interviews show that it is increasingly difficult for the corporate reporting model to meet the needs of users, preparers, auditors and regulators. Investors want forward-looking information about strategy, business models and the ability of the company to create sustainable long-term value. Preparers need to connect the dots better in their public communications so that the balance of risk and opportunity is clearer. Regulators are demanding much more information from companies.

<table>
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<tr>
<th>Name</th>
<th>Organization</th>
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<tr>
<td>Mervyn King</td>
<td>IIRC</td>
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<tr>
<td>Hans Hoogervorst</td>
<td>IASB</td>
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<tr>
<td>Russel Picot</td>
<td>HSBC</td>
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<td>Stephen Haddrill</td>
<td>FRC</td>
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<td>Neri Bukspan</td>
<td>Standard and Poor’s</td>
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<tr>
<td>Christoph Hütten</td>
<td>SAP</td>
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<tr>
<td>Joachim Schindler</td>
<td>KPMG International</td>
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<tr>
<td>Julie Hudson</td>
<td>UBS</td>
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<tr>
<td>Brian Hunt</td>
<td>CPAB</td>
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<td>Sandra Peters</td>
<td>CFA Institute</td>
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“As the world economy slowly recovers, it is time to consider where corporate reporting goes next.”
and more accountability from boards and managers.

Standard setters are equally dissatisfied. They believe that the bar needs to be raised for corporate reports. “The financial crisis was very much caused by faulty economic standards, faulty prudential standards or the abuse of standards and the gaming of capital requirements,” says Hans Hoogervorst, the chairman of the International Accounting Standards Board, the independent standard-setting body of the IFRS Foundation. “Clearly the market economy can only function well if it has a very solid set of standards and rules, and financial reporting is a very important part of that.”

All the interviewees agreed that corporate reports provide a good assessment of the financial condition of a company at a specific point in time. “In most cases, ticking the compliance box is something that financial reports do extremely well, but they are not conveying information in a clear and concise way; this view of financial reporting is held by institutional investors as well as among individual investors,” says Russell Picot, Group Chief Accounting Officer at HSBC.

Several of the interviewees said that the reports are backward-looking, that they’re too complicated and that the main points in reports are poorly connected to each other. One interviewee who holds this view is Mervyn King, chairman of the International Integrated Reporting Council (IIRC), which is developing a new reporting framework that integrates strategy, governance, performance and long-term prospects (the so-called integrated reporting). He says the average user finds corporate reports “incomprehensible.” The current reporting model is like “looking in the rearview mirror,” when in fact “the road ahead is very turbulent and there are huge impacts on the company, both societal and environmental.”

This makes it difficult for investors to assess the risks and the future direction of the company, both in the short- and long-term. Like many of those interviewed, Picot is critical of the quality of the risk analysis that companies publish. “It’s weak right now: you get a long description and a lot of numbers, but I think there are not many good examples of disclosures showing how a company has responded to changing risks and its use of relevant metrics,” he says. This is especially important for financial institutions. “We need to create a forum where banks can talk to investors, find out what they are worried about and respond rapidly to provide them with information,” he says.

Many interviewees said there was too much information in the corporate report. But not all accept the idea that corporate reports are weighed down with too much detail. One who doesn’t is Sandra Peters of the CFA Institute, who has been monitoring the views of the institute’s members. They are telling her that “it is not necessarily the volume of information, but the lack of a comprehensive story, which is where improvements in financial reporting are needed. Investors tell us there is a lack of ‘connecting the dots’ or pulling things together to communicate a cohesive story about a company’s results,” she says.

Neri Bukspan, Executive Managing Director and Chief Quality Officer of Standard & Poor’s Ratings Services, concurs and also makes a plea for ‘plain English.’ He adds: “We need to improve the information about what management thinks of the business in the context of its key performance indicators.”

Improved technology is going to help cut through the clutter. In particular, new software programs will enable preparers, auditors and users to handle ‘big data,’ the seemingly overwhelming flood of information that pours in and out of companies every day. “This will enable management and investors to understand why things are the way they are. Before, the focus of corporate reporting was on the ‘what,’ says Christoph Hütten, Senior Vice President and Chief Accounting Officer at SAP. Extensible Business Reporting Language (XBRL) will also help to link data points. It is true that technology is a necessary condition for enhanced transparency. But it is not sufficient by itself. There is no substitute for human judgment, in particular in deciding how to cater better to the needs of investors.

**What investors want**

Just as beauty is in the eye of the beholder, investors inevitably call the shots with regard to the importance of various communications from the company. And it is clear that they use the different forms of statement by companies in evolving ways. The
financial statement, summarizing and detailing the financial performance and balance sheet of the company, is a historical record that is treated as a work of reference. As investors (and executives) have focused more and more intensely on the short term, attention has shifted to the quarterly reports, but even these are losing their influence as a market-moving indicator, says Hüttel. “To catch the news, investors tend to rely on the quarterly press release and SAP’s conference call with financial analysts the same day of the release. And they use the quarterly report as an encyclopedic source for the details,” he says.

As the focus shifts from financial statements to other types of corporate communication, such as analysts’ briefings, should the latter be subject to some kind of assurance? “The main point is that any assurance needs to have a value to whomever it is provided. If this assurance provides insight and comfort to the audit committees, I am sure they will want auditors to look at it,” says Joachim Schindler, Global Head of Audit for KPMG International.

One question is how to craft a corporate report that looks forward in a way that is useful for readers. The directors’ report is crucial in this regard, because it provides a platform for the executives to explain the business model and the company’s strategy for pursuing its business objectives. The directors’ report should analyze as clearly as possible the risks the company may face in aiming to reach those objectives and how it plans to prepare for these possible eventualities.

Until now, however, most corporate reports are somewhat disjointed and there are often no clear links between the directors’ report and the financial statements. This is one weakness that integrated reporting focuses on, by telling the company’s story comprehensively and more effectively connecting all the information that is important for understanding the long-term health of the company. Many of those extolling the need for integrated reporting want to see a greater emphasis on environmental, social and governance (ESG) issues. Right now, many companies provide a sustainability report that discusses ESG matters, but this is usually separate from the main corporate report.

Mervyn King is one advocate of integrating sustainability reporting into the corporate report. Julie Hudson, a managing director at UBS, is another. In her view, there is no reason why ESG issues cannot be integrated into the corporate report right away. She says that if you look at traditional accounting, the framework is there to cover ESG-type non-financial issues. “So it’s a great puzzle to me as to why non-financial indicators should be in a separate part of the annual report, because if they matter then they should be included in the main part of the report,” she says.

Others may not feel quite so strongly about ESG issues, but they definitely want there to be more discussion about non-financial performance, even if it is likely to be harder to quantify than financial indicators. There is a strong sense that the real value drivers of the business, such as intangibles, are not captured in traditional accounting.

Two sides of the coin
Interviewees differed in their emphasis on sustainability indicators, but all agreed that the crux of the matter of new corporate reporting is the assessment of risk and opportunity. Executives see the business in these terms and so do investors. Hudson says that investors might tolerate greater risk if the opportunities were also perceived as greater. This links to the discussion of corporate strategy and the weighing of future risk and reward. “The point is not the exposure to the risk, but what is being done about it, and that comes down to strategy,” she says.

“In most reporting models there is a chairman’s statement and a directors’ report, but there are no parameters at the moment for there to be a story connecting the dots between strategy, risks and financial performance.”
The different dimensions of corporate reporting (short-term versus long-term; backward versus forward; financial versus non-financial; directors’ report versus the financial statements) tend to converge at this point. And this revolves around the question of providing a convincing argument to investors about the sustainability of a company’s business model, based on its strategy, the risks faced and how they are managed. “At the moment, we don’t have a real reporting framework for that,” says Schindler. “In most reporting models there is a chairman’s statement and a directors’ report, but there are no parameters at the moment for there to be a story connecting the dots between strategy, risks and financial performance.”

As the world (the Western world in particular) struggles to strengthen the financial system, nowhere is this emphasis on linkage more important than for financial institutions. In a situation such as the financial meltdown of 2008, banks have an obligation to refresh their financial disclosures in the light of the risks that are emerging, Picot says. Stephen Haddrill, Chief Executive Officer of the Financial Reporting Council, agrees about the importance of risk reporting. He says that the financial crisis has underlined the importance of understanding systemic risk. “Companies need to take a hard look at whether they are passing risk to another organization, if that is what they are intending to do, and, if so, what is the strength of the counterparty. We hope that the development of risk committees, particularly in financial services, will cause people to consider these matters more carefully,” Haddrill says.

“Enhance the role of audit committees so that they are more proactive in their discussions with auditors and management.”

Only connect

Interviewees unanimously wanted to see improvements in governance, so that companies can communicate better, not just with investors, but with auditors and with each other inside the company. One way of doing so is to enhance the role of audit committees, says Brian Hunt, Chief Executive Officer of the Canadian Public Accountability Board, so that they are more proactive in their discussions with auditors and management, particularly in terms of assessing audit quality and understanding the audit risks facing a company. The audit committee should set the appropriate environment for the discussion between management and auditors, especially among smaller companies. Others, such as Picot, called for more discussion between companies and investors, a point emphasized by Haddrill. “We at the FRC are keen to encourage a stronger dialogue between investors and companies, and we want to see the development of narrative reporting so that it remains of the highest possible value to investors and that companies are assisted in that, because investors want to engage on reporting and auditing matters. It has to be a two-way street,” Haddrill says. “We want to encourage investors, especially fund managers, in their stewardship role and through that dialogue with companies, to raise the quality of corporate reporting.”

The Great Depression triggered a transformation of corporate reporting. Will the 2008/2009 financial crisis have the same effect? International Financial Reporting Standards (IFRS) have already taken us part of the way. We now have something approaching a global language for financial statements. But along with the improved comparability, there was an increase in complexity and more of a tick-the-box approach to corporate reporting. Henceforth, we need to enhance the clarity of IFRS and integrate financial reporting better with the company’s discussion of its business model, as well as its strategy and the risks it faces. There is a limit to the degree to which financial statements can convey these messages, so other parts of corporate reporting are vitally important.

The financial crisis has made the need for global harmonization and integrated reporting more urgent. New technology will, in theory, make it easier to analyze corporate reports. But in practice, it will require a concerted effort of preparers, investors, auditors, standard-setters and regulators to move corporate reporting in the desired direction.
Global observations on the role of the audit committee

During 2013, the Federation of European Accountants (FEE), the Institute of Chartered Accountants in Australia (ICAA), and the Center for Audit Quality (CAQ), co-sponsored a series of three roundtable discussions in Brussels, Hong Kong, and New York City, attended by members of governance and audit committee communities in the respective jurisdictions.

The objective of the roundtables was to provide a forum for representatives from the global audit committee community, who share a common goal of strengthening audit committee practice, to determine the general level of global consensus on issues affecting the role of the audit committee and current state of performance.

Common themes emerged across jurisdictions related to attributes of audit committees that promote effectiveness, audit committee composition, scope of responsibilities, transparency, and the need for further education about the role of the audit committee to narrow the expectation gap.

Generally, participants in all jurisdictions emphasized the importance of the audit committee chair to be a strong leader in order to promote audit committee effectiveness. The chair should foster productive relationships with the board of directors, management, the external and internal auditors and the audit committee should serve as a communication hub for matters raised by these parties. The audit committee chair also should promote robust communication within the committee itself, and encourage audit committee members to ask critical questions of management, internal audit and the external auditor. At each roundtable, the benefit of an audit committee composed of members with diverse experience and expertise was emphasized, and a complement of financial and non-financial expertise was encouraged.

There was a focus at all three roundtables on the audit committee’s responsibilities with respect to risk management. Participants generally agreed that this is one of the most challenging areas facing the audit committee or, where available, by a risk committee working in liaison with the audit committee.

Participants also emphasized the importance of the audit committee being directly responsible for the determination of whether to recommend the appointment or retention of the external auditor to the board and/or shareholders. There was a lack of support for mandating firm rotation or retendering, which was viewed as undermining the role of the audit committee in determining the most suitable external auditor.

At each roundtable participants discussed whether and how the audit committee could provide further transparency about how it discharges its duties. While no consensus was reached on a clear path forward, there was recognition of public calls for more information in this area and the need to be responsive to the evolving needs of shareholders, in particular within the United States and European Union. Across jurisdictions it was acknowledged that the global audit committee community is now facing the same “expectation gap” that historically has presented a challenge for the auditing profession. Participants suggested that further stakeholder education on the role of the audit committee may serve to narrow this expectation gap.

The full summary report of the roundtable discussions is available for download free of charge from the publication section of the website of the Center of Audit Quality at www.thecaq.org/publications.

First comprehensive study on integrated sustainability reporting

The IRRC Institute (IRRCI) and the Sustainable Investments Institute (Si2) issued a report that is the first to comprehensively benchmark the status of integrated sustainability reporting in the US, noting that every company in the S&P 500 except one reports some form of sustainability disclosure, but fewer quantify those disclosures in terms of bottom line impacts.

By issue, the study identified the following trends:

- **Environmental management (disclosed by 68 percent of companies)**—Disclosures of capital expenditures on environmental controls were the most common. Many companies wrote about reducing overall operational risks as well as environmental spills and related cleanup and remediation costs, potential fines and lawsuits.

- **Employment (67 percent)**—Most companies noted the importance of attracting and retaining talent. Many described programs to engage employees on business topics, such as workplace issues and job satisfaction, as well as benefits to attract and retain them. They also referred to health plans, retirement accounts, job training and continuing education. Diversity also was mentioned as a key driver of business success. Health and safety risks were common notes too, as were risks related to poor employee relations, strikes and other work stoppages.

- **Climate change (66 percent)**—Many companies identified the energy efficiency of their operations and products as “low hanging fruit,” since they found investments in these areas produced returns competitive with contending demands for capital.

- **Hazardous waste (63 percent)**—Most companies described risks related to hazardous waste in their annual Form 10-K filings; this was the only sustainability topic discussed by a majority of companies in any one specific reporting format. Many of these disclosures related to pending litigation. Hazardous waste also was the area where companies were most likely to place a dollar amount on their activities.

- **Product formulations (54 percent)**—These disclosures included product lifecycle assessments, as well as the marketing of green, fair trade or other types of sustainable products. Most disclosures were made in sustainability reports.

- **Waste management (49 percent)**—Companies primarily addressed efforts to reduce packaging and to move manufacturing operations toward producing zero landfill waste.

- **Water use (39 percent)**—Companies viewed water principally as a cost or as a potential risk due to scarcity.

- **Ethics (21 percent)**—Fraud and related ethics topics were often discussed in a context of compliance with legal requirements.

- **Human rights (15 percent)**—The issue least talked about as a business opportunity; the human rights issue was most frequently described as a reputational risk, specifically with regard to suppliers’ use of child or forced labour or operations in conflict zones.

The full text of the report is available for download free of charge from the research page of the IRRCI website on www.irrcinstitute.org/projects.php?project=63

**Auditor selection: Towards best practices**

Companies are changing their auditors more frequently than in the past, in response to market and other demands. As a good selection process is essential if there is to be a transparent selection that enhances audit quality and ensures auditor independence, a new publication of FEE proposes ways in which the process of selecting an auditor can be performed most effectively.

The publication intends to foster the public debate and aims to share best practices for a high-quality process when selecting the auditor in the applicable environment by:

- A more transparent and informed auditor selection process
- Ensuring an appropriate focus on the quality of the audit
- Contributing to the selection of an auditor who is independent, in accordance with applicable laws and regulations.

According to FEE, this raises two important questions to which answers will have to be found in the selection process in accordance with the company’s specific circumstances: what is audit quality? and what is the value of an audit?

The full publication is available for download free of charge from the publication section of the website of FEE at www.fee.be
About us

Recognising the importance of audit committees, the Audit Committee Institute (ACI) was created to serve audit committee members and help them to adapt to their changing role. ACI provides knowledge to audit committee members and is a resource to which they can turn for information or to share experience.

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