Audit Committee Institute

On the 2020 Audit Committee agenda

Prioritising a heavy audit committee agenda is never easy, and 2020 will be particularly challenging as the audit committee operates against a backdrop of global volatility and economic uncertainty, in a world where investors and stakeholders are becoming increasingly powerful and informed.

Drawing on insights from our conversations with audit committees and business leaders we highlight the issues that boards should keep in mind as they approach and execute their 2020 agendas.

Controlling the agenda

This number one priority from last year holds true for 2020. Nearly half of the 1,300 audit committee members responding to our *2019 Global Audit Committee Survey* said it's "increasingly difficult" to oversee the major risks on the audit committee's agenda in addition to its core oversight responsibilities over financial reporting and controls, and internal and external auditors.

Aside from the raft of new agenda items, the risks that many audit committees have had on their plates for some time – those around financial planning; cyber security; IT; ESG; supply chain; operations; legal and regulatory compliance; etc. – continue to become more complex.

Reassess whether the committee has the expertise and time to oversee the risks it has been assigned. Do cyber risk and data governance require greater attention from the full board or perhaps a dedicated committee that might tap into relevant skills from outside the board? Keeping the audit committee's agenda focused will require discipline and vigilance in 2020.

Assessing the scope and quality of ESG disclosures

Nearly all listed companies provide some form of environmental, social, and governance (ESG) or sustainability reporting, but there are growing concerns by a range of stakeholders – investors, employees, customers, regulators, and activists – regarding the quality, comparability, reliability, and usefulness of such information.

ESG reporting has been of growing importance to institutional investors for many years, with investors demanding more information and seeking engagement with companies on core ESG issues and their impact on the company. While employee and consumer activism regarding ESG issues is in its early stages, it is growing exponentially, particularly among millennials.

The proliferation of climate and sustainability related regulations and frameworks create a complex matrix of behaviour and reporting requirements for companies to consider. Despite this, the overwhelming voice is for more disclosure.

Given the increasing stakeholder demands for more transparent, higher quality ESG reporting – as well as understandable concerns about the lack of comparability of ESG data – the audit committee can serve as a catalyst, recommending that the board encourage management to reassess the scope and quality of the company's ESG reports and disclosures. This may be a significant undertaking and would likely include complex and time consuming activities such as benchmarking against peers; consideration of the methodologies and standards of various firms that rate companies on ESG practices; understanding the expectations of investors and other stakeholders; and reviewing various ESG reporting frameworks for possible use by the company.

Does the current board have the right mix of skills to deliver on this? Should the audit committee consider acting as a formal oversight body for the activity? Consider the need for the company secretarial team to be part of these discussions to help ensure that the necessary infrastructure – controls and procedural – is in place.

The FSB Task Force on Climate-related Financial Disclosures (TCFD) are working to develop consistent climate-related financial risk disclosures for use by companies in providing information to investors, lenders, insurers, and other stakeholders. While currently a voluntary system, the UK government has an announced an intention to require TCFD disclosures by 2022 – this affords an opportunity for companies to put themselves ahead of the game by making this high profile topic a priority for the coming reporting cycles.

Reinforcing audit quality

Audit quality is enhanced by a fully engaged audit committee that sets the tone and clear expectations for the external auditor and monitors auditor performance rigorously through frequent, quality communications and a robust performance assessment.

Probe the audit firm on its quality control systems that are intended to drive sustainable, improved audit quality – including the firm's implementation and use of new technologies.

In discussions with the external auditor regarding the firm's internal quality control system, consider the results of IAASA and any internal inspections and efforts to address deficiencies. Remember that audit quality is a team effort, requiring the commitment and engagement of everyone involved in the process – the auditor, audit committee, and management.

Pay close attention to the audit reform agenda – in particular the Competition and Market Authority's (CMA's) Final Report on the Statutory Audit Market with its proposals for increased scrutiny of audit committees; mandatory joint audits and peer reviews; as well as an operational split between the Big Four's audit and non-audit businesses intended to ensure maximum focus on audit quality.

Regulation

Is the board clear on the company's regulatory responsibilities? Hundreds of new requirements are released every year across the world and in today's global market staying on top of your responsibilities is a significant task. Ensure that the support for ownership of the process sits comfortably in the business. Engage directly with the company secretarial team in order to ensure that they have a handle on what is required. Can they provide a clear picture of the situation today? Do they have visibility over the pipeline of regulations? Do they have the resources to stay on top of it?

Monitoring corporate reporting

In times of uncertainty, whether created by political events, general economic conditions or operational challenges, investors look for greater transparency in corporate reports to inform their decision-making. Carefully consider the detail provided in those areas of the annual report which are exposed to heightened levels of risk; for example, how the going concern considerations have been approached, the impact of Brexit and all areas of material estimation uncertainty.

A specific issue affecting this season's year end reporting are the published amendments to IFRS 9 and IAS 39, reflecting the global reforms of interest rate benchmarks, such as LIBOR, the futures of which post 2021 are not clear in a number of cases. In terms of reporting, ensure that robust processes support the judgements as to whether the level of uncertainty is so high that the conditions for hedge accounting are not met. All companies that are parties to contracts referencing LIBOR, or any other rate subject to the reforms, should start planning now for the transition to new rates. This should include early consideration of the need to re-negotiate relevant contracts and agreements.

Stand back and think about all the awkward areas 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. Be conscious of what your peer companies are reporting and be prepared to be challenged on anything which appears inconsistent.

Focussing 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, which supports the company's strategy, including its 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.

Coupled with the challenging global regulatory environment – the array of new data privacy, environmental, healthcare, financial services, and consumer protection regulations, as well as the UK Bribery Act and the US Foreign Corrupt Practices Act (FCPA) – compliance risks and vulnerabilities will require vigilance.

The responsibility for directors to assess and monitor culture comes front and centre in the updated UK Corporate Governance Code – the need for a sharp focus on behaviours (not just results) and yellow flags, in the tone at the top as well as the culture throughout the organisation. Does the company's culture make it safe for people to do the right thing, and speak up when they see behaviour to the contrary?

Help ensure that the company's regulatory compliance and monitoring programmes are up to date, cover all vendors in the global supply chain, and clearly communicate the company's expectations for high ethical standards. 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? 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 full display.

Leveraging the impact of technology

Major technology changes impacting finance functions present important opportunities for them to reinvent themselves and add greater value to the business. As audit committees monitor and help guide progress in this area, we suggest three areas of focus.

First, recognising that as much as 60 to 80 percent of the finance function'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 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.

And third, as the finance function combines strong analytics and strategic capabilities with traditional financial reporting, accounting, and auditing skills, its talent and skill-set requirements must change accordingly. Is the finance team attracting, developing, and retaining the talent and skills necessary to match its evolving needs? In this environment, it is essential that the audit committee devote adequate time to understand the finance function's transformation strategy.

Engaging with shareholders

Shareholder engagement continues to be a priority for companies as institutional investors increasingly hold boards accountable for company performance and demand greater transparency, including direct engagement with independent directors. They continue to challenge the board with tough questions around the broad topics in this agenda as well as specifics around their role in company strategy and risk evaluation, and the findings from their own self-assessment.

In order to ensure they have the full picture, boards should request periodic updates from management about the executive level engagement practices: Do we regularly engage with our largest shareholders and understand their priorities? Do they have access to the right people? What is the board's position on meeting with investors? And perhaps most importantly, is the company providing investors with a clear, current picture of its performance, challenges, and long-term vision?

Be mindful of the company's vulnerabilities to activist investors. Activism need not be short-term nor undermine the board's strategic thinking – done properly it can help focus the strategy and drive enhanced corporate governance. Play the role of activists by looking at the company from the outside-in and prompting change from within to benefit shareholders.

As reflected by the 2019 voting trends, strategy, executive compensation, management performance, ESG initiatives and board composition will remain squarely on investors' radar during 2020. We can also expect investors to focus on how companies are adapting their strategies to address the economic and geopolitical uncertainties and dynamics shaping the business and risk environment in 2020.

Broadening the benefit of internal audit

In recent years, a number of highly publicised corporate crises have damaged company reputations, due in part to failure to manage key risks such as tone at the top and culture, legal/regulatory compliance, incentive structures, cybersecurity and data privacy, ESG risks, and global supply chain and outsourcing risks. The audit committee should work with the head of internal audit (and chief risk officer) to help identify the risks that pose the greatest threat to the company's reputation, strategy, and operations and to help ensure that internal audit is focused on these key risks and related controls.

Is the audit plan risk-based and flexible – and does it adjust to changing business and risk conditions? What's changed in the operating environment? What are the risks posed by the company's digital transformation and by the company's extended organisation – sourcing, outsourcing, sales and distribution channels? Are we sensitive to early warning signs regarding safety, product quality, and compliance? What role should internal audit play in auditing the culture of the company?

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

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