On the 2019-20 audit committee agenda

The current business environment and new regulations have put governance in the limelight. Independent directors and audit committees now have enhanced responsibilities. This coupled with disruptions in business due to technology, accounting, tax and trade updates and threats from external and internal sources require audit committees to widen their horizon and consider various aspects of the business while considering their financial year 2019-20 agendas.

Drawing insights from KPMG International's recent interactions with audit committees and business leaders over the last 12 months, we've highlighted some important items that audit committees should keep in mind as they consider and carry out their 2019-20 agendas:

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

We continue to hear from audit committee members that it is increasingly difficult to oversee the major risks on the committee's agenda in addition to its core oversight responsibilities (financial reporting and related internal controls and oversight of internal and external auditors). Aside from any new agenda items, the risks that many audit committees have had on their plates are cybersecurity and IT risks, supply chain and other operational risks, and legal and regulatory compliance – has become more complex, as have the committee's core responsibilities. Keeping the audit committee's agenda focussed will require vigilance.

Sharpen the company's focus on culture, ethics, and compliance

The reputational costs of an ethics or compliance failure are higher than ever. Fundamental to an effective compliance programme is the right tone at the top and culture throughout the organisation—one that supports the company's strategy and commitment to its stated values, ethics, and legal/regulatory compliance. This is particularly true in a complex business environment as companies move quickly to innovate and capitalise on opportunities in new markets, leverage new technologies and data, and engage with more vendors and third parties across longer and increasingly complex supply chains. Closely monitor the tone at the top and culture throughout the organisation with a sharp focus on behaviors, not just results. Help ensure that the company's regulatory compliance and monitoring programs are up-to-date and cover all vendors in the global supply chain and clearly communicate the company's expectations for high ethical standards.

Focus on the effectiveness of the company's whistle-blower reporting channels and investigation processes through a #MeToo lens.

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

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

First, recognising that the bulk of finance's work involves data gathering, what are the organisation's plans to leverage robotics and cloud technologies to automate as many manual activities as possible, reduce costs, and improve efficiencies? Second, how will finance use data and analytics and artificial intelligence to develop sharper predictive insights and better deployment of capital. Third, as the finance function combines strong analytics and strategic capabilities with traditional financial reporting, accounting, and auditing skills, its talent and skill sets must change accordingly. It is essential that the audit committee devote adequate time to understand finance's transformation strategy.

Focus internal audit on the company's key risks beyond financial reporting and compliance

As recent headlines demonstrate, failure to manage key risks—such as tone at the top; culture; legal/ regulatory compliance; incentive structures; cybersecurity; data privacy; global supply chain and outsourcing risks; and environmental, social, and governance risks—can potentially damage corporate reputations and impact financial performance. The audit committee should work with the chief audit executive to help identify the risks that pose the greatest threat to the company's reputation, strategy, and operations and help ensure that internal audit is focused on those risks and related controls.

Recent accounting changes and updates

For financial year 2019-20, some of the recent accounting changes and updates which may be a game changer for corporate India are as follows:

- **Enhanced focus on other information in auditor reporting:** From 1 April 2018, Standard on Auditing (SA) 720 (revised), *The Auditor's Responsibilities Relating to Other Information* has been applicable in India. SA 720 defines other information as financial or non-financial information (other than financial statements and the auditor's report thereon) included in an entity's annual report.

  Annual reports include a lot of qualitative and quantitative information. The information provided by annual reports is used by users of the financial statements to analyse the risk associated with business and in decision making.

  Depending on the applicable law, regulation or custom, one or more of the following documents may form part of the annual report:

  – Management report, management commentary, or operating and financial review or similar reports by those charged with governance (for example, a director's report)

  – Chairman's statement

  – Corporate governance statement/reports.

  The auditor's responsibilities relating to other information (other than applicable reporting responsibilities) apply regardless of whether the other information is obtained by the auditor prior to, or after, the date of the auditor's report.

  Therefore, the audit committee in consultation with the management establishes the process for sharing other information with auditors. In order to develop a well – rounded understanding of the entity, audit committee members should engage in a dialogue with the external auditors early.

- **New accounting standards:** The audit committee should understand the new accounting standards that would be applicable to the company. For example Ind AS 116, *Leases* is effective from 1 April 2019. This standard is converged with International Financial Reporting Standard (IFRS) 16, *Leases.* The new standard is likely to have significant impact for all companies as lessees. It eliminates the classification of leases as either finance leases or operating leases as required by Ind AS 17, *Leases*. It introduces a single on-balance sheet accounting model that is similar to the current finance lease accounting model. Therefore, a majority of operating leases will be on-balance sheet of a lessee as if it has borrowed funds to purchase an interest in the leased asset. This accounting will make entities look asset-rich but at the same time heavily indebted too.

  The scope and complexity of implementation efforts and the impact on the business, systems, controls and resource requirements should be the key area of focus for audit committees. While the impact will vary across industries, many companies – particularly those with large, complex contracts will experience a significant accounting change when implementing the new standard. The audit committee should work with the Chief Financial Officer to understand the impact of the leases standard on the financial statements and key financial metrics. They should also inquire about the new judgements, assumptions and estimates that would be applied to determine lease identification, classification and measurement of lease transactions.

  The application of the new standard may require entities to reconsider their contract terms and business practices such as changes in the restructuring/pricing of transaction including lease length and renewal options.

Amendments to SEBI Listing Regulations

The Securities and Exchange Board of India (SEBI) has been playing an active role in strengthening the role of the board and those charged with governance of listed entities. On 28 March 2018, SEBI implemented certain key recommendations made by the Kotak Committee to improve standards of corporate governance through amendments to the SEBI Listing Regulations. The amendments cover various facets of governance, including the composition, role and functioning of the board and its committees, oversight over group entities and related party transactions, enhancing transparency and disclosures, etc. Some key amendments applicable from 1 April 2019 are that the board of directors of top 1,000 listed entities should have a minimum of six directors of which there should be at least one independent woman director. Disclosure of consolidated financial statements on a quarterly basis and a cash flow statement on a half – yearly basis has been made mandatory for all listed entities. Additionally, the quantification of audit qualifications has been made mandatory and the auditor would need to review and report, with the exception being only for matters like going concern or sub – judice matters.

The audit committee members should make inquiries and assess the implementation of the key amendments impacting the company and how the management is addressing due compliance of these amendments.

Personal Data Protection Bill, 2019

On 25 May 2018, the EU enacted the General Data Protection Regulation (GDPR) which establishes the right to privacy as one of the fundamental rights. While the GDPR regulations apply to the EU, in today's global marketplace, the impact is being felt far and wide.

Recently, on 27 July 2018, India issued the Personal Data Protection Bill, 2019 (PDPB) along the lines of the GDPR. PDPB is likely to affect businesses that deal with customers and will transform the way that personal information is collected, stored, used, disclosed and disposed of. PDPB extends the territorial scope to ensure that even organisations, not physically located in India but offering goods and services in India, are regulated under the PDPB.

A data privacy mandate is a critical component of this bill. Therefore, this is a key agenda for audit committee to ensure compliance to the requirements of the PDPB.

Cybersecurity/risk management

In an increasingly connected and fast-paced business environment, cybersecurity has been identified as one of the top risks faced by businesses. Despite this, companies may not be fully prepared for a cyber-event, and continue to underinvest in cybersecurity. The cyberattacks result in significant damage, spanning from financial losses, disruption of operational services to erosion of shareholder value and trust. Accordingly, there is a need to constantly evolve and create an effective cyber resilient environment.

Audit committees should drive companies to implement a strategic, holistic approach to cyber preparedness that will not only protect the valuable data, but also enhance the company’s agility and better position it for growth down the road.

Related party transactions

The nature of related party relationships is such, that transactions with them are not considered to be independent. In the recent years, it was observed that most of the high profile frauds were executed on collusion with related parties. This increases an onus on audit committees to ensure that proper systems are in place and directors have been made responsible to identify and disclose related party relationships. Sometimes, many related parties may operate via an extensive and complex network of relationships, making them difficult to unravel. Therefore, it is imperative to ensure that internal controls and information systems are effective in identifying and recording the related party relationships and transactions, and whether they are on normal commercial terms.

While reviewing and approving transactions, audit committees should understand the business reasons for entering into the transactions, whether these are in line with the company’s overall strategy and objectives and whether these are at arm’s length price . Also, consideration should be given to how these transactions would be disclosed, their overall impact on the financial statements, and how the investors would view them.

Thus, regular review of related party transactions is crucial to keep in check the overall risks associated with them.

Non - GAAP financial measures

Generally, companies and investors communicate through key performance indicators (KPIs) or non – GAAP measures alongside the GAAP measures. This topic has prompted much debate. When do KPIs enhance GAAP by aiding communication with users, and when do they present a confusing or overly optimistic picture? Therefore, non – GAAP financial measures that a company discloses outside of its financial statements should be transparent and comparable.

It is critical that non – GAAP financial measures have a prominent place on the audit committee agenda. Have a robust dialogue with the management about the process – and controls – by which management develops and selects the non – GAAP financial measures it provides, their correlation to the actual state of the business and results, and whether the non- GAAP financial measures are being used to improve transparency and not to distort results.

Whistle-blower policy

The increasing complexity of global organisations is expanding the opportunities for fraud in a variety of areas. It is the responsibility of audit committees to address the various fraud risks head-on ensuring that appropriate safeguards are in place.

Whistle-blowing procedures are a major line of defense against fraud, and it is the responsibility of the audit committee to ensure that the use of this is encouraged, and the procedures surrounding it are effective.

In India, listed companies are mandated to devise an effective whistle blowing mechanism. While the ultimate responsibility for the same rests with the board as a whole, audit committees are typically tasked with the principal oversight of the processes in place to make sure that management has fraud risk management right. The audit committee plays a vital role in evaluating the organisation's culture to which employees will contribute positively if they are confident that it is fair, transparent and ethical and if there is evidence that this culture is initiated by the tone set at the top.

Whistle- blowing is closely knitted to an organisation's culture. Effective whistle-blowing systems contribute to a sound corporate culture but can only take place in an environment that encourages concerns to be raised without fear of retaliation.

While evaluating the effectiveness of the whistle-blowing systems, the audit committee should inquire whether the staff and stakeholders are aware of the processes established by the management, and if the hotlines or reporting lines, actually work (especially where no instances have been reported). Effectiveness of the systems would also be affected based on whether the systems being used, audit committees should assess whether there are any factors hindering employees or other stakeholders from applying these policies. These could range from fear of not getting adequate legal protection or of being victimised, thus adequate controls should be in place to ensure confidentiality of whistle-blowers or providing them with safe harbour..

Review of financial statements and recommendations to the board

The current uncertain and volatile business environment and the complexity of financial reporting regulation are particularly difficult for the management. The overall responsibility for preparing the annual reports and other financial information is with the management. However, the audit committee needs to apprehend the pressures on the management, whether it be with respect to meeting market expectations on earnings, meeting targets, or other personal motives, which include heavy dependence of incentives and other remuneration on performance of the company. Considering this, it is imperative that the audit committees have a skeptical mind while reviewing the financial information reported by management. A regular two-way dialogue between the audit committee and the management is essential, and the audit committee may also look to the external auditor for support, using their insights to help to identify potential issues early.

The audit committee should participate in the overall review process by understanding and assessing the appropriateness of the significant accounting policies adopted by the management, and estimates and judgements made. In case of unusual and complex transactions, audit committees should inquire about the business rationale for the transaction, and whether its disclosure is appropriately made in the financial statements in context of its accounting and an overall impact on the financial statements.

The audit committees should liaise with the external auditors, right from the beginning, by communicating their expectations from the audit, and whether the audit strategy and plan would effectively address the issues raised. The audit committee should seek an overview from their external auditors on the key elements of risk based audit that has been planned such as extent of audit coverage, audit focus areas, materiality, etc. They should review the external auditor's presentation on key audit matters, recommended audit adjustments and disclosure changes, focussing on both the adjustments and changes made by management and those that management has not made. They should review the auditor independence and seek a specific confirmation from the company's external auditors.

It is important that the audit committee members keep themselves updated with the latest corporate reporting developments. Accordingly, they should consider the impact on the organisation's corporate reports of any changes to accounting standards, generally accepted accounting practices and other corporate reporting developments.

Understand business segments' performance

Over the last decade, the audit committee's focus has largely been on compliance, governance and a variety of approval issues. However, given the audit committee's expanding role in overseeing risk, there are various emerging areas where it can deliver enhanced oversight value. This includes measures to review the overall performance of the company and of specific segments within the company by comparing the performance against targets and the previous year KPIs. The audit committee should insist that business heads provide an overview of the performance of the segments and how segment goals support the overall strategic goals of the company. This includes by assessing the quality of in-year management and monthly/quarterly reports submitted.

Audit committees should also measure whether the systems and controls in place are robust and whether they can measure the defined KPIs.

About KPMG Board Leadership Center (India)

KPMG's Board Leadership Center champions outstanding governance to help drive long-term corporate value and enhance investor confidence through an array of programmes and perspectives. The Center engages with directors and business leaders to help articulate their challenges and promote corporate governance. Drawing on insights from professionals and governance experts from KPMG member firms worldwide, the Center delivers actionable thought leadership – on risk and strategy, talent and technology, globalisation and compliance, financial reporting, and audit quality, and more – all through a board's lens.

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