Audit committee evolution
2014 and beyond

Enhancing audit committee effectiveness

- The audit committee’s agenda continues to evolve as companies are faced with a rapidly-changing global business landscape, the proliferation of standards and regulations, increased stakeholder scrutiny, and a heightened enforcement environment.

- Companies are confronted with emerging risks, such as cyber and broader IT risks, including those related to mobile computing, cloud-based technologies, intellectual capital, data privacy, big data, and social media. In some cases, this may translate to expanded responsibilities for audit committees if they are charged with overseeing these risks.

- Strengthening relationships with management and auditors that facilitate robust and candid discussions about the effectiveness of risk management, internal controls, and other accounting and auditing matters that could impact financial reporting is critical to the continued effectiveness of the audit committee.

- Audit committees will need to continue to transform and evolve in response to the changing environment. Leading audit committees are setting a strong tone at the top, owning their agenda, building strong relationships with auditors, and evaluating their informational needs and their own performance.

Highlights

- The business and regulatory landscape continues to rapidly evolve, introducing new risks that can expand audit committees’ agendas if they are tasked with overseeing these risks.

- New accounting standards, emerging issues and trends, and regulatory changes also require careful monitoring.

- Audit committees should proactively control their agenda and ensure they’re provided with the most useful information.

- Effective relationships that are facilitated by a productive exchange of information in support of the committee’s agenda are essential.
Audit committee agendas are impacted by a changing environment

**The role of the audit committee**

The audit committee has primary responsibility for overseeing the integrity of the company’s financial statements and related disclosures. This includes oversight of how the company addresses and manages the implementation of new accounting standards and regulations.

Audit committees frequently take on additional responsibilities, including oversight of risk management. In fact, audit committees of NYSE-listed companies are required to discuss a company’s policies with respect to risk assessment and risk management. Many audit committees also oversee companies’ key risks related to fraud and compliance. And, depending on board decisions, their responsibilities may also expand to oversee emerging risks like cybersecurity and IT.

**Increasing financial reporting requirements**

Financial reporting disclosure requirements have been increasing for a number of years. Filing documents have generally become longer and more complex.

Companies continue to face an array of new standards, rules, and regulations that can have significant financial reporting implications and broader business impact. For example, the new revenue recognition standard will impact virtually all companies. It can impact top-line revenue as well as a company’s strategic plan, controls, information systems, and incentive plans, among other areas. In addition, new regulations such as Basel III, the Volcker Rule, and money market reform will result in the need for process and reporting changes for certain financial institutions.

Disclosure of information outside of the financial statements (e.g., non-GAAP measures and sustainability reporting) is also proliferating. This information can provide additional insight into a company’s performance and cash flows, but also has the potential to impact a company’s stock price—so ensuring balanced and consistent reporting remains a high priority for audit committees.

**The pace of technological change**

Changes in technology that are implemented to drive growth, increase efficiency and productivity, and reduce costs often come with new risks. Cybercrime is now commonplace. Although a company’s board will determine whether it or a committee will have oversight responsibility for cyber risks, this charge often goes to the audit committee.

**Heightened regulatory environment and stakeholder scrutiny**

Companies are dealing with a complex web of constantly evolving regulations across national and international borders. At the same time, they are contending with the pervasive global threat of economic crime. This presents challenges for many companies, as regulatory organizations have increased their pursuit of enforcement actions. Major fines can be levied on companies, and their reputations can suffer. Protecting the company’s brand and reputation is becoming a bigger part of the audit committee’s agenda.

In addition, the difficult economic situations in many countries and the related challenges of fiscal deficits have combined to increase the public debate around taxes and their impact on financial reporting. Companies expend significant effort to manage compliance with complex tax rules and the related accounting standards. Notwithstanding full compliance with the tax laws and regulations, some companies are being negatively impacted by a public perception that they are not paying their “fair share” of taxes on income. Why? Even though a company may have paid all required taxes in all jurisdictions, some may perceive and assert that it has “taken advantage” of tax rules and paid too little.

This has brought managing tax risks and protecting the company’s brand into the spotlight for many audit committees, as stakeholders have increasingly shown interest in these areas.
Audit committees must continue to transform and evolve

What can audit committees do?
Leading audit committees embrace transparency and set a strong tone at the top, along with taking the following actions.

Control the agenda
Audit committees have a lot on their plates, so they must prioritize their agendas to focus on the most relevant matters. They may also be challenged with “information overload,” which can distract them from focusing on the most significant issues. This means critically evaluating their agenda to ensure a focus on key risks, relevant IT matters, internal audit strategy, and other matters that contribute to effective oversight is a must.

Build relationships
Effective interactions with management and auditors are crucial to ensuring the audit committee is focused on key risks, emerging issues, and standards that could impact the company. Having robust, open dialogue and welcoming healthy debate is critical to enhancing these relationships.

There is significant value in the private sessions between the audit committee and the external auditor. These sessions allow audit committees to ask probing questions about matters such as management’s performance and tone, internal control, and other accounting and financial reporting issues. A private session with the external auditor provides an opportunity to candidly discuss fraud risks or other difficult or contentious matters. And, it allows the audit committee to seek the auditor’s views on other matters, such as resources allocated to cyber risks or major systems changes.

Understand the business
To be effective, the audit committee must understand what information it needs and what questions to ask to make informed decisions. Knowing the organization and its risks are imperative. Effective audit committees engage in educational sessions to better understand complex or new areas of financial reporting, including risks and unusual and/or complex transactions.

Having robust discussions about fraud risks is critical. Understanding risk factors, such as pressures to meet earnings or the company’s approach to tax risk (including reputational risk), reviewing results of whistleblower complaints, and reviewing reports on fraud prevention programs are among other key considerations.

Get the right information
Companies continue to face an array of new standards, rules and regulations that can have broad implications on financial reporting and governance. Leading audit committees will want to proactively engage in transparent discussions with management and auditors about these matters and their potential impact on operations and financial reporting. Management and auditors may want to take a “fresh look” at their existing reporting to identify if any information they provide to the audit committee needs to be enhanced, changed, or possibly eliminated.

Assess performance
One of the more important things an audit committee can do is to review its performance with a continuous improvement mindset. While not all audit committees are subject to the NYSE listing requirement to perform an annual performance evaluation, an assessment can be an effective way to develop a plan for improvement. This critical process may highlight a need to examine important matters, such as the audit committee’s composition or prioritization of its agenda.

Conclusion
As the business and regulatory landscape continues to change, audit committees’ agendas will also evolve. As a consequence, audit committees must continue to transform and evolve. This may not call for radical change for many, but some will want to consider if they are setting a strong enough tone at the top, reevaluate their interactions with management and auditors, take a closer look at their informational and educational needs, and critically evaluate their own performance.
Questions and answers

Q: What new or emerging accounting standards should audit committee be aware of?

A: Management should be keeping the audit committee up-to-date on new or proposed accounting standards that could impact the company’s financial reporting.

The relevance and degree of impact a new standard will have depends on a company’s business model and related factors. Some new accounting standards management may want to consider include:

- Revenue recognition: While it generally isn’t effective until 2017, virtually all companies will see some level of impact. There may be broad implications for some companies when adopting the standard, such as on information technology systems, processes, internal controls, contracts and compensation plans.

- Discontinued operations: This standard can be adopted in 2014 and, in many cases, is expected to significantly reduce the number of disposals that will qualify for discontinued operations treatment.

In addition, the FASB has launched a simplification initiative in an effort to reduce complexity in accounting and financial reporting. As a result, several items have been added to its agenda which could be acted on quickly (e.g., simplifying the measurement of inventory).

Q: What are some tactical considerations that can be employed by internal audit to maximize its value to the audit committee?

A: Internal audit should develop a risk-based audit plan that leverages the group’s capabilities and addresses the company’s key risks. Internal audit will want to ensure that it has the skills and capabilities needed. This may mean adding talent or using external resources in the areas of critical business risks, business continuity, data privacy, and security.

Internal audit should ensure it is providing the audit committee with the right information (e.g., appropriate amount and type). The information may go beyond the findings of completed audits to include matters such as risk management processes, IT risk, compliance and regulation, and data management. It is also important for the audit committee to provide feedback to internal audit on its performance.

Q: What other resources are available?

A: Visit PwC’s Center for Board Governance audit committee resources page to learn about the latest insights on governance issues and trends.