Audit committee perspectives through a European lens

IAASA AC Briefing, 10 September 2020

Tim Volkmann

EY
Building a better working world

Agenda

- A Period of Transition
- Audit committee responsibilities
- A view on the current and future role of audit committees
- Excursus: Non-Financial Reporting / Impact of COVID-19
- Audit committee realities and the future
- Opportunities for improvements
- Discussion

A period of transition

- The **advance of digital technologies** is changing the nature of business in many industries and enhanced **public concern over the behavior and environmental impact** of the private sector.
- Companies are facing both **new risks, and greater scrutiny** over their operations.
- As a result Audit committees (ACs) are undergoing a **period of transition** – transforming from backward-looking committees focused on a narrow financial remit, to more forward-looking bodies tasked with evaluating a wider set of risks.
- EY produced a study based on information gained from over 20 discussions conducted by Oxford Analytica with current AC members in **France, Germany, Italy, the Netherlands, Sweden and the UK**, as well as discussions with academic experts in corporate governance and board systems, and in-depth desktop research into each of the countries studied.
- Tapestry Network – organizing also the European Audit Committee Leadership Network (EACLN) – produced the report on ***'Audit Committee Realities: Insights from Leading European Boards'*** based on a survey and interviews with 55 audit chairs across the EU

Audit committee responsibilities required by the EU audit legislation

Reporting

- A core activity of audit committees is overseeing corporate reporting, including annual reports, interim reports, and other communications to investors and the public. Committees focus on accounting practices and on internal controls over financial reporting. They also discuss the reports themselves. In addition, audit committees review non-GAAP (generally accepted accounting principles) financial reporting and nonfinancial reporting, sometimes turning to the external auditor for assurance in these areas.

Overseeing the external auditor

- Audit committees closely monitor their external auditors, conducting performance evaluations, partner rotations, and reviews of non-audit services. They review the external auditor's audit plan and consider key audit risks, audit scope and coverage. They monitor oversight of the local audit teams and often meet with members of the local audit team when visiting local company offices. They review key judgments made by the external auditor such as impairment tests, and estimates for contingent liabilities. They look for proactive communication and independence on the part of the auditor, as well as proficiency in technical accounting principles and auditing standards. They inquire about internal audit quality findings and inspection reports from audit regulators. The partner rotation process is led by the audit chair with input from members of management and final approval by the audit committee and the board. Some audit chairs are reluctant to approve non-audit services from the auditor, chiefly because of concerns about independence, while others more readily acknowledge the value of these services.

Leading the audit tender

- The ARD requires many European-based companies to tender more frequently than they once did. The audit committee owns and directs the process, while management supports it. The Big Four audit firms typically are the only candidates. In considering potential candidates, audit committees manage compliance with "cooling off" periods for audit firms currently providing non-audit services. Audit committees contend with complexities arising from mandatory rotation rules that are not consistent between countries. Audit committees distinguish between firms largely based on available quality, expertise, and audit technology, and they evaluate lead partners and engagement teams more subjectively.

Internal audit

- The internal audit function and chief audit executive are important partners for an audit committee, which often spends substantial time and effort assessing and supporting the function. Areas of discussion include the audit plan, specific internal audit issues, risk management issues, the internal audit function's performance and capabilities, relations with management, and relations with the external auditor.

Audit committee responsibilities derived from governance codes, company law, and practice

Risk management

- Most boards delegate a substantial portion of the oversight of enterprise risk management to their audit committees. Committees review risks and mitigation plans at a high level, then allocate risk accountabilities within the board, keeping some for the audit committee itself.

Compliance

- Audit chairs look for well-drafted, strict codes of conduct supported by effective training, controls, and assurance. Boards are under pressure to promote cultures of compliance, and audit committees increasingly assess corporate culture as part of their compliance oversight. Audit committees usually oversee management programs for employees to report misconduct, including "speak up" programs and whistleblower hotlines. When dealing with allegations of significant financial misconduct, or involving senior leaders, the audit committee may directly oversee the investigation itself.

Cybersecurity

- By utilizing members' expertise and by developing techniques to evaluate company cybersecurity practices, audit committees help the full board oversee the company's cybersecurity.

Tax strategy

- Audit committees often play a key role in the board's oversight of tax by balancing the pursuit of tax savings with countervailing regulatory and reputational risk considerations and by overseeing the tax function.

Major transactions

- Audit committees often provide oversight in the diligence and post-transaction phases of major deals. They may also become involved at the start of transactions.

Funding and liquidity

- Boards often rely on the financial expertise of their audit committees to oversee funding and liquidity. Audit committees routinely look at funding options and ability to manage debt. During crises, they may review the health of key business partners.

Investor engagement

- Some investors say that they are interested in learning more about audit committee activities, but few audit chairs report having been contacted by investors and some have concerns about engaging directly with investors.

Structural differences and competing views on roles

- With **differing national board structures** including one- and two-tier boards, and variations in size and rates of activity, ACs in Europe both look and feel different from each other
- These divides are most clear in the **breadth of role taken by ACs**, with some ACs already having accepted a broader set of responsibilities, and others remaining focused on their traditional activities.
- ACs within the Netherlands appear to have the **largest remit in terms of competencies**, as they are asked to evaluate risks over a long-term time horizon and in external parts of the firm's operating environment, making them more naturally concerned with non-financial risks
- This is in contrast with ACs such as those in Switzerland and the UK, which have a **narrower focus on company financials, related risks and internal controls**, staying heavily focused on the traditional work of an AC and external auditor supervision
- This divide in outlook, between a narrow definition of the role and a more expansive one, **sets the tone for how ACs view the evolution of their role**, the skill sets required, and how to engage with less defined tasks

EY

Relationship with management, internal and external audit

- Some AC members, particularly in two-tier board structures such as Germany, view their role and that of the board toward management as **mainly supervising the execution of company strategy and policies**
- Other ACs generally view their role as **multi-faceted and requiring different approaches** depending on the circumstances and what is being discussed
- Most ACs understand their role as being a **collaborative or consultative partner with management** on the setting of strategy and objectives, such as risk control frameworks and thresholds, **and then a supervisory role** when it comes to the execution of the resulting plans
- There is general consensus around the best practice of **direct control over the two audit functions and internal controls** by the AC, with the committee representing the most important stakeholder for both audit functions. Therefore, when it comes to the traditional tasks of overseeing the internal audit and controls process as well as the external audit review of company accounts, ACs — regardless of system — take a relatively uniform approach to both those relationships and their responsibilities.

Limited engagement with external stakeholders

- Broad consensus also exists among ACs in how to engage with key external groups, particularly investors and relevant regulators
- For the **investor community**, ACs remain silent despite being perhaps the most visible committee in any board structure. They (have to) leave engagement to management based on regulatory responsibilities, despite the external facing nature of their work and the evident stakeholder interest in financial accounts.
- Formal contact with **regulators** was also almost universally shunned at the company level, with ACs relying on informal discussions between AC Chairs and regulatory bodies to articulate their views
- There is also some **reliance on larger groups**, such as the one that brings together the AC Chairs of the DAX 30 in Germany to provide formal commentary on new regulation and legislation

EU Audit Reform — demonstrating a difference in perspective

- While no clear national divide appears to exist between the outlooks taken by ACs on the EU Audit Reform, the different means they use to address it — either an **input- or an outcome-based approach** — serves as a clear indicator of a difference in perspective among ACs in Europe
- Those concentrating on outcomes are **monitoring the outcomes of the overall audit process** to ensure the integrity of the financial reporting process
- Those following an input-based process will hold **extensive discussions with the external auditor prior to commencement of the audit**

Setting the agenda — from tactical issues to looking ahead

- Two perspectives are used to frame the AC agenda:
  - one that is **tactical, focusing on current business issues or newly-enforced legislation**, and
  - one that is concerned with **emerging trends and issues that could develop over a longer time horizon**
- Breadth or narrowness of an AC's remit serve as the main differentiating factor, and not structural differences such as a one-tier or two-tier board structure
- Traits such as the responsibility of Dutch ACs to consider cyber risks and external stakeholders create a demand for Dutch ACs to be **forward-looking and consider risks that are not yet present**
- ACs in systems with a narrower set of responsibilities, such as the UK and Italy, are focused solidly on **solving tactical issues related to changes in regulation, M&A activity, or other firm-specific tasks**
- Firms in France and Germany straddle this divide, **oscillating between the two approaches**

Excursus 1: Review of the 2014 Non-Financial Reporting Directive

Context

In its Communication on the European Green Deal, the Commission committed to **review the Non-Financial Reporting Directive (NFRD) in 2020** as part of the strategy to strengthen the foundations for sustainable investment. This consultation is one element of a broader consultation strategy.

Key elements of the proposed framework for NFI reporting

An inclusive standard setting process

- EU key role to ensure a legal framework for robust standard setting
- Independence from external factors (e.g. political interferences), impartiality, and due process
- A greater nexus between financial and non-financial information (NFI).
- Inclusive multi-stakeholder approach: considering different stakeholders' views and leveraging existing frameworks/standards.
- Flexibility allowing for diversity of sectors and materiality assessments.

Robust external assurance on NFI statements

- Assurance standard for consistent high-quality assurance of NFI
- Independent and competent assurance providers
- Responsibilities of management and audit committee with regards to the preparation of financial information extended to NFI reporting.
- Approval of the NFI reporting by the governing body of the company
- Public regulatory oversight responsible to supervise the effectiveness of the NFI reporting system as established by the NFRD.

Why is it relevant?

- Work of audit committees is increasingly moving towards sensitive topics and emerging risks that impact on trust and confidence in corporates
- COVID-19 as a catalyst for topics such as sustainable finance and non-financial reporting on the EU agenda
- Evolution of corporate reporting is speeding-up with a focus on alternative performance aka non-GAAP measures and non-financial reporting such as ESG/CSR and specifically climate change

Potential impact

1 **Impact on reporting and assurance given a greater nexus between financial and non-financial information**

2 **Impact on risk management e.g. with a view to compliance with new laws and regulations or (financial) reporting risks, as demands for new types of information raise the question of what internal controls are needed to ensure accuracy and consistency**

EY

Excursus 2: Impact of COVID-19

COVID-19 crisis has resulted in severe macroeconomic effect, increased volatility and uncertainty in capital markets. Governments around the world have reacted with unprecedented monetary and fiscal policy actions. There are challenges for financial reporting and audits effecting the work of audit committees

1

Judgements and underlying estimates in a fast-changing, unprecedented environment

- Project future operating results and cash flows as a means of addressing fundamental elements of financial reporting
- Uncertainty in making judgements (e.g. duration of pandemic, macroeconomic impact, time and shape of recovery, availability of fiscal/financial support and ultimate effect on future operating results and cash flow)
- Even valuation experts uncertain about future markets

2

Balancing timeliness of financial reporting while ensuring it is trustworthy and insightful

- Financial reporting process likely requires greater preparer and auditor effort in the current environment
- Preparers and regulators must balance timeliness of reporting against its reliability.
- Some authorities have recognized this and provided relief from reporting deadlines. Some preparers are, however, not currently using such relief.

3

Remote working

- Restrictions on travel and requirements to stay at home increase the need for new tools and technologies
- Practical and technical challenges remain, e.g. inability to physically access audit locations to undertake procedures like attending inventory counts; inability to obtain original documents such as entity-provided documents used in testing or third-party confirmations; legal restrictions in some countries, that limit the transfer of data outside the jurisdiction

➢ The crisis underscores the importance of:

√ **Robust and engaged audit committees**

√ **Comprehensive disclosure of forward-looking information**

√ **Effective internal controls**

√ **Appropriately assessing going concern and disclosing substantial doubt/material uncertainty when it exists**

Audit Committee Realities: takeaways from Tapestry Network report

- Audit chairs view the **impact of 2014 EU audit legislation** as mainly positive from their perspective
- Audit committees and their chairs provide **robust challenge to external auditors**
- **Technological transformation** poses ongoing challenges and opportunities for audit committees and their chairs
- The increasing **burden** on audit committees often falls disproportionately **on the audit committee chair**
- Audit committees have become “first stops” as **new risks surface**
- Audit committees have **deep reach into finance functions**
- Audit committees work with more and more **executives outside finance functions**
- Audit committees are **careful not to cross from oversight into management**
- There are **different ways to do the job** well

Quotes from audit committee chairs across Europe

“

I tell the auditor, the only way you can make me mad is if you surprise me. I describe it as a race between management and the auditor to see who will tell me the news first. That’s the level of responsiveness that I expect.

On overseeing the external auditor

“

As the chair of the audit committee, one of my most important relationships is with the head of internal audit. You should build enough trust so that he can say to you, ‘The CEO might be committing fraud.’

On interaction with internal audit

“

Initially, I thought the audit committee should be in charge, but the differences between financial and ESG reporting are great. A specialized ESG committee could be better. One practice can be for the ESG committee to invite the audit committee chair from time to time to advise.”

On overseeing ESG reporting

“

The risk committee focuses on outcomes, and the audit committee focuses on controls. We manage the overlap by having some members sit on both committees.

On risk management and coordination with other committees

“

I actually support or encourage non-GAAP financial measures because that’s the only way the reader can really know what’s happening at the company. The audit committee has to make sure this reporting improves understanding and is calculated in a proper way.

On overseeing non-GAAP measures

“

We have split the tasks so that our technology committee handles the ‘what and how,’ and the audit committee then assesses whether the decisions—processes, routines, documentation, and follow-ups—are implemented and followed.

On responsibility for cybersecurity oversight

“

The direct contact between the audit committee and the auditors, with free and open contact, is a good way to understand issues.”

On communication with the external auditor

“

In a complex world, you have to have specialists on the team.

On demonstrating audit proficiency

The future of audit committees – key questions

How will audit committees and audit chairs manage the growing burden of risk oversight?

Risk workload – expertise in climate change and cyber risk – outside expertise vs expanding training

How will audit committees oversee new types of reporting?

Financial vs non-financial information - ESG performance - stakeholder expectations – related control and assurance issues – long-term value creation (LTV)

How will new technologies affect audit committees?

Techonolgy transforming companies' finance, internal audit and compliance functions, as well as external audits – understanding of technology – impact on audit committee practice

How will audit committees draw the line between oversight and management?

Maintaining a distinction between appropriate oversight and excessive intervention – need for deeper knowledge and supervision of management activities – balanced involvement

How will audit committees and investors interact?

More investor attention to audit committees – conduct of investor outreach

Where will the audit reform go from here?

Benefits of current audit reform – investor, regulators and other stakeholders potentially asking for more – what additional changes would give stakeholders more confidence in reporting, audit quality and market valuations

Opportunities for improvement

**Finding the effective balance between today's operational and reporting challenges and tomorrow's unseen risks is the greatest challenge facing European audit committees today.
To accomplish this task, and stay fit for purpose, European audit committees should…**

1. Establish a clear best practice for their involvement in **overseeing CSR reporting and the creation of an audit** (in contrast to a review) for those statements

2. Acknowledge the **need to add skills** relevant to the digital tools, processes and systems impacting internal business functions and the role of internal and external audit

3. Consider **adjusting board committee tenure** to help bring those new skills into the AC more quickly

4. **Engage more openly and formally with regulators and policy makers** to help minimize any negative impacts from the increasing pace of regulatory change

Corporate reporting, and the governance that supports it, needs to evolve urgently

EY

Discussion

EY | Assurance | Tax | Transactions | Advisory

About EY
EY is a global leader in assurance, tax, transaction and advisory services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. Information about how EY collects and uses personal data and a description of the rights individuals have under data protection legislation are available via ey.com/privacy. For more information about our organization, please visit ey.com.