On the 2020 audit committee agenda
Board Leadership Center (India)
Prioritising the audit committee agenda

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

Aside from the discussion on new agenda items, the risks that many audit committees have had on their plates for sometime – those around financial planning, cybersecurity, Information Technology (IT), Environment, Social and Governance (ESG), supply chain, operations, legal and regulatory compliances, etc. continue to become more complex. Audit committees should reassess whether they have the expertise and time to oversee the risks assigned to them. Do cyber crime 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 focussed and relevant will require discipline and vigilance in 2020. Drawing on insights from our conversations with audit committees and business leaders, we put forth seven areas that audit committees should keep in mind as they approach and execute their 2020 agendas:

1. Reinforcing audit quality
2. Assessing the scope and quality of ESG disclosures in BRR
3. Technology and its impact on finance organisations
4. Keeping pace with the accounting developments
5. Recent regulatory developments
6. Related parties - identification and compliance
7. Assessing the internal audit function’s performance
1. Reinforcing audit quality

Executing audits consistently within a strong system of quality controls is fundamental to 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.

In India, the National Financial Reporting Authority (NFRA) is empowered to review the financial statements of a company/body corporate within its jurisdiction. It can also direct personal presence of officers of the company/body corporate and its auditor for seeking additional information or explanation.
Points to consider

- 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. This may include review of audit firm’s management structure and processes, including tone at the top, how the firm responds to deficiencies in audit quality and independence policies and procedures.

- Understand and discuss the processes that the auditor has in place to address any regulatory inspection report.

- Dedicate some audit committee meetings to deep dive on select specific topics (e.g. governance processes, culture in finance function, cybersecurity, quality of accounting estimates, choice of accounting policies, materiality, reporting timelines, etc.) and having the auditor provide feedback on best practices or other trends witnessed by them. The committee should carefully evaluate the financial impact of business strategy, plans, practices, policies and transactions and give the auditor a proper focus for his/her work.

- Conduct an assessment – on at least an annual basis – of the engagement team and audit, including discussions around what went well and what could be improved. Regular private conversations between the chair and the audit partner, to assess independently any concerns.

- Communication with management on a periodic basis emphasising the importance of audit quality and the quality of information available in the company. Identification and communication of concerns should be timely with management to emphasise on importance of audit quality.

To reiterate, ensuring audit quality is a collective effort, requiring the commitment and engagement of everyone involved in the process - the auditor (external and internal), audit committee, independent directors and management.
2. Assessing the scope and quality of ESG disclosures in BRR

In our experience, Indian listed companies provide some form of Environment, Social and Governance (ESG) or sustainability reporting disclosures as part of their Corporate Social Responsibility Report, Business Responsibility Reports (BRR). However, internationally there are growing concerns by a range of stakeholders – investors, employees, customers, regulators, and activists – regarding the quality, comparability, reliability, and usefulness of this information.

Capital markets regulators in India, the Securities and Exchange Board of India (SEBI), and the Ministry of Corporate Affairs (MCA) require certain disclosures to be provided by listed companies such as disclosure on whether the company has a mechanism to recycle products and wastes, disclosures regarding strategies/initiatives to address global environment issues such as climate change, global warming, etc. These disclosures include significant communication of information to stakeholders through company’s website, annual reports, financial statements, etc. These disclosures are time and again being enhanced by the markets regulators to bring enhanced transparency and quality in non-GAAP financial disclosures.

Given the increasing stakeholder demands for more transparent, higher quality ESG reporting – as well as 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.
Points to consider

- Agree on the definition of ESG and its importance to the company.

- Determine which ESG risks and opportunities are of significance to the company.

- Encourage integration of material ESG issues to business strategy.

- Shape the ESG communication keeping in mind investors and other stakeholders in the context of long term value creation.

- Ensure that the board has the right composition, structure and processes to oversee ESG in the context of long term value creation.
Major technology changes impacting finance functions present important opportunities for them to reinvent themselves and add greater value to the business. 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 analytical capabilities should evolve to include predictive analysis, an important opportunity to add real value. In this environment, it is essential that the audit committee devote adequate time to understand finance transformation strategy.
Points to consider

- Recognise that as much as 60 to 80 percent of the finance function’s work involves data gathering, therefore, understand what are the organisation’s plans to leverage robotics and cloud technologies to automate as many manual activities as possible i.e. reduce costs, and improve efficiencies.

- Understand how will finance use data analytics and artificial intelligence to develop sharper predictive insights and better deployment of capital.

- 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. Discuss if the finance team is attracting, developing, and retaining the talent and skills necessary to match its evolving needs.
4. Keeping pace with the accounting developments

For the 2020 agenda, Ind AS 116, *Leases*, accounting for uncertain tax treatments and interest rate reforms form the key areas of accounting change.

The impact of the new standard on leases (applicable from 1 April 2019) is not limited only to financial reporting. It may prompt changes to certain contract terms and business practices - e.g. changes in structuring or pricing of lease agreement, including the type of variability of lease payments and the inclusion of the options in the contract.

The amendment regarding uncertain tax treatment clarifies how to apply the recognition and measurement requirements of Ind AS 12, *Income Taxes* when there is uncertainty over income tax treatments.

The shift in the benchmark interest rates with alternative nearly risk-free interest rates is expected to have a cascading effect beyond contract terms into the operations and financial reporting of many companies. To address some of the pre-replacement issues, in September 2019, the International Accounting Standards Board (IASB) has issued amendments to International Financial Reporting Standard (IFRS) 9, *Financial Instruments*, International Accounting Standard (IAS) 39, *Financial Instruments: Recognition and Measurement* and IFRS 7, *Financial Instruments: Disclosures*. The amendments modify some specific hedge accounting requirements to provide relief from potential effects of the uncertainty caused by the Inter-bank Offered Rate (IBOR) reform. Further, the amendments require entities to provide additional information to investors about their hedging relationships which are directly affected by these uncertainties.

Companies with hedges affected by the IBOR reform would need to take steps to apply the amendments, which are mandatory and effective from 1 January 2020.
Points to consider

- For leases, an ongoing monitoring is required to ascertain how changes in contract terms over the period of lease are being evaluated by the companies. Ensure that the new estimates and judgement thresholds used in identification, classification and measurement of lease transactions are properly documented and corroborate with the judgements used.

Evaluate whether sufficient quantitative and qualitative disclosures have been provided to enable users of the financial statements to assess the impact leases have on the company’s financial position, financial performance and cash flows. Also, ascertain whether additional disclosures are needed to meet the overall objective of communication with the stakeholders.

- For uncertain tax treatments, understand the judgements, assumptions and other estimates used by the management, discuss the potential impact of uncertainties that are not reflected in the financial statements. Additionally, enquire about the company’s approach towards interest and penalties related to the uncertain tax treatments.

- For interest rate reforms, understand the impact of the change on the financial statements and risk management activities of the companies. Discuss the need for early consideration to renegotiate relevant contracts and agreements.
5. Recent regulatory developments

The recent regulatory developments relate to mandatory disclosure of loan defaults, whistle blower policy, insider trading and introduction of an informant policy. These have been explained below:

- **Mandatory disclosure on loan defaults:** Currently, SEBI regulations require listed entities (with listed Non-Convertible Debt securities (NCDs)/Non-Convertible Redeemable Preference Shares (NCRPS)) to provide specific disclosures on certain matters such as delay/default in payment of interest/redemption of NCDs and NCRPS for a period of more than three months from the due date. Effective 1 January 2020, additional disclosures are required to be given to the stock exchange in case of default in payment of interest/installment obligations on loans (including revolving facilities like cash credit) from banks/financial institutions and unlisted debt securities in the following manner:
  - **In case of default on loans (including revolving like cash credit) beyond 30 days:** Disclose the fact to the stock exchange immediately but not later than 24 hours from the 30th day of such default.
  - **In case of default on unlisted debt securities i.e. NCDs and NCRPS:** Disclose the fact to the stock exchange immediately but not later than 24 hours from the occurrence of the default.

- **Whistle blower policy, insider trading and informant mechanism:** Reputational costs of an ethics or compliance failure are higher than ever. Coupled with the challenging regulatory environment, compliance risks and vulnerabilities will require vigilance. In India, listed companies are mandated to devise an effective whistle blower mechanism that enables employees, their representatives, and other stakeholders to freely communicate concerns about illegal or unethical practices. Whistle blowing procedures are an important line of defense against fraud and audit committees have a key role in ensuring such procedures are effective.

Recently, SEBI has introduced a formal informant policy under the SEBI (Prohibition of Insider Trading) Regulations, 2015 (SEBI PIT Regulations)² to uncover the insider trading cases faced by the corporates in India. A whistle blower would have an option to report insider trading concerns directly to SEBI instead of approaching the listed company.

1. Default mean non-payment of the interest or principal amount in full on the date when the debt has become due and payable (‘pre-agreed payment date’). For revolving facilities like cash credit, an entity would be in ‘default’ if the outstanding balance remains continuously in excess of the sanctioned limit or drawing power, whichever is lower, for more than 30 days.
2. SEBI PIT (Third Amendment) Regulations, 2019 dated 17 September 2019 effective from 26 December 2019.
Points to consider

- Understand the process in place to ensure compliance regarding disclosures required to be given to the stock exchange in case of default in payment of interest/instalment obligations on loans including revolving facilities like cash credit from banks/financial institutions and unlisted debt securities.

- Focus on the effectiveness of the company’s whistle blower reporting channels and investigation process. Understand the entire process from receipt of new information through remediation. Obtain reports which should provide details relating to volume of issues, sources of information and the nature of the issues being identified. Enquire about whether concerns raised are responded to within a reasonable time frame and whether there are procedures to ensure that all reasonable steps have been taken to keep the identity of the whistle blowers confidential.

- Understand the policies and procedures that ensure compliance with SEBI PIT Regulations including those relating to Unpublished Price Sensitive Information (UPSI). Understand how the routine data is protected. Understand the contractual coverage of third parties and ‘insiders’ dealing with UPSI. Ensure that in case of UPSI leakages, whistle blower policies are sufficiently robust. Examine how the existing financial statement closure process is safeguarded along with subsidiary-level material financial information is safeguarded.

- Understand whether the company’s culture make it safe for people to do the right thing. Ensure that the company’s regulatory compliance and monitoring are up to date, covers all vendors in the global supply chain and clearly communicate the company’s expectation for ethical high standards. As a result of the radical transparency enabled by social media, the company’s culture and values, commitment to integrity and legal compliance and brand reputation are on full display.
Related Party Transactions (RPTs) is an area of focus for all stakeholders, especially the regulators, auditors and shareholders. Owing to the high profile frauds in recent times, the ‘independence’ of the RPTs has widely been questioned by the public. Due to this, regulators in India mainly the Ministry of Corporate Affairs (MCA) through the Companies Act, 2013 (2013 Act) and the Securities and Exchange Board of India (SEBI), in the Listing Regulations lay a lot of emphasis on identification and compliance for RPTs.

Identification and compliance of related party relationships may be challenging. Many related parties may operate via an extensive and complex network of relationships, making them difficult to unravel. This increases an onus on audit committees to ensure proper systems are in place and directors have been made responsible to identify and disclose RPTs.
Points to consider

For each transaction which is brought for approval of the audit committee, the committee should ask relevant questions, for example:

- Are controls to identify related parties adequate and operating?
- Is there a business reason for this RPT and is it in line with the company’s objectives and strategy?
- What is the impact of the RPT on the financial statements?
- Is the RPT on an arm’s length and in the ordinary course of business?
- Who will be the beneficiaries of the RPT?
- How will the investors view such RPT?
- Is the process of approving the RPT by the audit committee documented and is there clarity on further approval process by the board of directors/shareholders?
- Does the audit committee receive all the relevant information to make informed judgements to support appropriateness of the RPT?
- Is review of RPTs included as a scope of internal audit?
- What is statutory auditor’s view on RPTs?
The audit committee should work with the chief audit executive 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 risks and related controls.

Additionally, audit committee should 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.
Points to consider

- Does the internal auditor have direct access to the board chairman and to the audit committee and is accountable to the audit committee?

- Does the audit committee review and assess the annual internal audit work plan?

- Does the audit committee receive a report on the results of the internal auditors' work on a periodic basis?

- Does the audit committee review and monitor management's responsiveness to the internal auditor's findings and recommendations?

- Does the audit committee meet with the head of internal audit at least once a year without the presence of management?

- Does the audit committee monitor and assess the role and effectiveness of the internal audit function in the overall context of the company's risk management system?
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