ADAA AUDIT COMMITTEE update

ADAA highlights issues for the AUDIT COMMITTEE

August 2015

At a glance – on the AUDIT COMMITTEE agenda

ADAA's hot topics

Toshiba scandal exposes Japan's governance flaws. 140 year old company shocks investors.

KPMG's 2015 Global Audit Committee Survey. Short of a crisis, the issues on the audit committee's radar don't change dramatically year on year (and they probably shouldn't) so if the issues don't change what can we learn from KPMG's survey?

- ***A deeper understanding of the business***
- ***CFO succession planning***
- ***Audit reform***

Accounting considerations? **Revenue, Provisions, Control, Fair Value**, and **Leasing**.

Changes to the audit report.
Is Internal Audit delivering to its full potential?

The detail

Sound judgments and estimates require a disciplined and unbiased attitude.

Audit committee members more effective with a better understanding of the business strategy and risks

It is no surprise collusion kept the knowledge from the Auditor. It always does!

Toshiba scandal exposes Japan Inc.'s governance flaws. 140 year old company shocks investors. Toshiba touches many facets of our lives. From TVs and laptops to nuclear power and railways we all have experiences of Toshiba's products.

As the President and most Board members fall on their swords it's sad to hear the Tokyo investigating panel concludes corporate culture is to blame. No-one likes delivering bad news to a boss but worse is a boss who will not hear bad news.

It is four years since the Olympus scandal and in those four years people in Toshiba knew the problem was ticking along.

This is not a Japanese problem, it's a world problem, the UK had the same situation with Tesco, India the same with Satyam. The Libor rate rigging the same thing too. The responsibility for culture starts and ends at the top.

In previous publications we talked about a relationship triangle between the Company, the Audit Committee, and the Auditor. We interviewed the Chair of the Audit Committee, the CFO and the Auditor and all said strong governance was vital and when it isn't there that's when things go wrong. So who's to blame?

It is the role of Audit Committee members, Internal Auditors, and Statutory Auditors to suspect and to find out. It is no surprise collusion kept the knowledge from the Auditor. Collusion always does, which is why the Auditor must consider if collusion is going on. This is a primary duty of Internal Audit and Audit Committee members.

Knowing when something the Executives are saying is not right is a core skill. Being brave enough to do something about it is easy because its a professional responsibility. Access previous ADAA publications here.

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- ***A deeper understanding of the business***

Perhaps a surprise finding. Audit committee members say they would be more effective if they had a better understanding of the business strategy and risks, more 'white space' time on the agenda for open dialogue, greater diversity of thinking, perspectives and experiences and technology expertise. Is it coincidence one of the failings reported by the Tokyo panel was two from four non-executive directors were diplomats not business people?

There is an auditing standard on understanding the business and assessing controls - ISA 315. Too often too much focus is given on evidence supporting an end judgement, the contract for example. A contract is merely a written form of verbal intent as evidenced by contract disputes. Written forms can be wrong. To discover the real intent of why management entered into a contract, the economic benefits and the commercial risks of the transaction need to be understood.

The comment for more 'white space' makes real sense.

- ***CFO succession planning***

Assessments of CFO performance and interactions with the audit committee are generally viewed as effective. Well they would be wouldn't they or would the CFO not be sacked?

Digging deeper the issue is more about understanding the nature and various aspects of the finance team's work. Are they partnering the business and adding value, or merely keeping the score?

- ***Audit reform***

Since 2008 there is virtually no country of the world that has not been touched by audit reform. We have new auditing standards, new accounting standards and new regulatory bodies. But is it enough?

Mandatory auditor rotation rules have been introduced to change the audit market and drive up quality. Will it work?

Only if the opportunity is taken to ensure you have a robust and challenging audit. Just box ticking a clean opinion is not enough.

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The detail - continued

Accounting considerations? Revenue, Provisions, Control, Fair Value, and **Leasing**.

IFRS 15 Revenue. It may not be effective yet but revenue is a key performance measure and your CFO should be able to say if revenue might look different. It is of no surprise that in investigating cases of fraudulent financial reporting the PCAOB found revenue was the number most often misrepresented. The old standard found increasingly complex transactions difficult. The new standard focuses on performance obligations – so what are these?

If you buy an airline ticket you don't just get a ticket. If you used your credit card you may get points from your bank. When you fly, the airline will give you points, and when you have enough, you can fly for free, or use them to upgrade. You may also get status points on your way to becoming a gold member which provides benefits like free food and drinks in the airport lounge and the occasional free upgrade at the gate. Perhaps yours is a business ticket and you booked the limousine service.

There are potentially more than seven performance obligations embedded in the ticket purchase, revenue is attributed to each. The risk of getting it wrong is very small for a transaction where the major part is recognised in taking the flight. But what about engine supplier?

Rolls Royce supply engines and engine maintenance agreements. They have arrangements with their suppliers whereby the supplier pays an upfront fee to Rolls Royce in exchange for a share of the revenues over the life of the engine program. Thus when Rolls Royce sells engines and maintenance agreements to customers the agreement has to be split between revenue for the engine, revenue for the maintenance services and revenue to the supplier and these revenues must all be fair values.

IFRS 9 Provisions. Are to be made for amounts expected to be lost and not just for amounts lost. You may be thinking, in a well-controlled business with credit checks on customers are these amounts not the same? For most businesses they are. But when a business has a customer who is paying over a long period of time, Banks for example, provisions might be expected to rise and fall in reflecting the changing economic circumstances of customers.

IFRS 10 Control. The best way of keeping losses off the balance sheet is to not consolidate them in the first place (ask Enron). So if you have made a significant minority investment, what control do you have over it?

IFRS 13 Fair value measurement. Is a topic that always appears in the Regulators list of top five significant audit deficiencies. Measurement guidance used to be dotted around in different standards. Now it's in one place. Fair value is not an invention of IFRS but IFRS championed it because of the inherent limitations of historic cost. However, whilst historic cost was simple, easy to audit and unlikely to result in overstated assets in the balance sheet, fair value seemingly does not share these characteristics. Odd really when since the launch of Lotus 1,2,3 in the 1980s the accountant's most trusty friend has been the spreadsheet.

Spreadsheets however have inherent flaws. Built in controls are poor, so mistaken and fraudulent entries are easily made. They have no audit trail and duplicate entries hard to find, and that is before the soundness of management estimates and judgements is assessed.

Good judgement requires a disciplined and unbiased approach and for assumptions and estimates to be based on market provable data. Audit committee members should assess carefully the reasonableness of the assumptions used and ask for alternatives to be provided; best case, worst case, most likely.

It is vital management estimates are challenged because all estimates are inherently wrong (hopefully not by much). The key question for the Audit Committee is how far wrong management might be?

Finally how do the judgements sit together? Are they balanced? Just because management can point to a standard and demonstrate compliance with IFRS for every judgement does not mean the financial statements will comply overall. If the Income Statement reports a profit and the cash flow statement reports negative cash from operations take another look something might not quite be right. Estimates need to err on the side of prudence and not be overly aggressive.

Does the accounting treatment adopted fall in line with industry practice and best practice? If you are a government entity why should the accounting be aggressive? Overly prudent accounting favours the sons and daughters of Abu Dhabi – is that not the way it should be?

IAS 17 Leasing. Clearly not a new standard but it's coming soon. Leverage could be a problem if the liability is brought on balance sheet and is caught in a banking covenant.

Changes to the audit report. In 2016 for listed entities the Statutory Auditor's report will include narrative of key risks identified and how they were addressed. This not a small matter and cannot be underestimated. It is a good idea to dry-run the new approach in advance.

Is Internal Audit delivering to its full potential? KPMG report 50% feel Internal Audit should deliver greater value. Members want delivery of a strong understanding of internal controls. Financial and compliance risks rightly consume a large portion of Internal Audit's resources however a strong focus should be given to operational risks too.

For more information on the topics in this issue please access the links below:

Audit Committee Trends 2015 - KPMG
Harvard Corporate Governance & Financial Regulation
IFIAR 2014 Survey
Audit Committee 2015 Survey - KPMG
Audit Committee Agenda 2015 - Protiviti

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جهاز أبوظبي للمحاسبة
ABU DHABI ACCOUNTABILITY AUTHORITY

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