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Audit Change on the Horizon
Article by Stephen Davis
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Audit committee chairs may find resonance in the phrase “tragedy of the horizon”, an expression coined in 2015 by Bank of England governor Mark Carney, which refers to the paradox that arises when market actors must take urgent action to address a long-term risk—but have no observable short-term incentive to do so. Carney was talking about climate change. But his warning can be read as a routine job description for board directors. Of course they have to monitor a company’s current business operations. But they also need to keep a weather eye on changes on the horizon that may not be obvious to executives in charge of day-to-day management and who, as a result, may resist such insights. Perhaps no area is in more need of such dual attention from directors than the outside audit. Board members in GCC companies—especially those in audit committees who are on the front line—have a clear responsibility to oversee compliance with current rules. But radical changes in the external audit appear to be coming: in what is being assessed, how, by whom, and for whom. It may be true that scandals and crises elsewhere are to blame for potentially radical reforms. But board directors in the GCC are likely to be seeing the effects on home turf before very long. So now may be an appropriate time to scan the horizon so that companies can be prepared.
Drivers of change

First, let’s look at what is prompting growing attention to the external audit. The last time capital markets saw the public policy spotlight swing this far to auditing was in the aftermath of the 2001 Enron scandal. Fraud at the Houston-based energy trader caused the US Congress to legislate the landmark Sarbanes-Oxley Act. Among other things, the statute required CEO certification of financial accounts; creation of the Public Company Accounting Oversight Board (PCAOB) to watchdog audit firm quality; limits on auditor consulting; restrictions on related-party transactions; and financial literacy standards for board audit committees. Enron’s collapse also led to the epic global dissolution of Arthur Andersen, one of the Big Five, as the audit giants numbered then. Reverberations in the form of new law, regulation, and practice were felt in GCC states as well as elsewhere.

Today the path toward what one conference company calls the “Global Crisis in Audit Firms” stems from multiple factors. Corporate failure, once again, is the leading cause. The high-profile collapse of construction firm Carillion, despite healthy audit reports, fueled a broad UK bipartisan attack on the alleged oligopoly of audit. Charges that KPMG in South Africa skewed audits to advantage the Gupta family as well as disgraced ex-president Jacob Zuma similarly drew unwanted attention to the profession. Indeed, once-unthinkable investor votes have exposed levels of distrust: in 2018 some 35% of shareholders at troubled GE voted against KPMG as the firm’s auditor while 78% voted against Deloitte at UK construction firm SIG.

But this time systemic trends beyond scandal also lie behind the push for change. For one, the striking rise of public and private sector attention to so-called intangible variables contributing to risk and opportunity has given birth in Europe and North America to a whole industry of specialized standard setters and assessors of environmental, social, and governance (ESG) factors affecting company performance. Investor attention to the Sustainable Development Goals, accelerated by bodies such as the UN Principles for Responsible Investment (PRI), has helped propel increasingly sophisticated corporate management of, and reporting on, extra-financial variables that reside outside traditional audit coverage. These are developments that are here to stay, and which are ramping up pressure on the audit process to capture the relationship of such variables to value and risk.

Secondly, the recent expansion of stewardship teams especially at the largest fund management firms - Blackrock, Vanguard, and State Street Global Advisors- signifies an historic transformation. Where once such funds applied perfunctory, compliance-driven reviews of the governance and audit features of portfolio companies, they now increasingly devote analysis-rich scrutiny to the monitoring of firms they co-own anywhere in the world. We are only at the inception of the ‘stewardship era’, which has already triggered a rapid escalation of board-shareholder engagement on ESG risks. Over time, it is likely that big institutions will be devoting more resources to strengthening relationships with outside audit firms, and urging them to be more relevant, as a way of asserting their stake in effective outcomes.

Three emerging trends in global external audit

GCC audit committee chairs and members are required throughout the region to serve as the company’s front line in selecting, setting terms of reference, and monitoring outside auditors of company accounts. But the following three meta trends flowing from the systemic evolution described above appear destined to destabilize what was once a predictable responsibility.

1. Who audits?
When Arthur Andersen imploded, it left just four big accounting firms capable of handling audits for multinationals. Policy makers and
market actors have shown periodic anxiety about the consequences of so few players. They have worried that relative lack of competition would raise barriers to entry for potential new rivals, impair independence, and reduce audit quality. Markets sought to address these concerns with regulation—in particular, the PCAOB and equivalents. But the failure of Carillion has made the UK ground zero in the push to go well beyond previous measures and break up the Big Four. If radical steps are taken there, it would likely have repercussions throughout the global business community.

There are reasons to suspect that this time UK regulators may take those steps. For one, in April 2018 the government named Sir John Kingman to conduct an inquiry into the efficacy of the Financial Reporting Council (FRC) as the national regulator of the audit industry. One month later a parliamentary committee piled on pressure, calling on the Competition and Markets Authority (CMA) to consider splitting up the Big Four and separating their audit and consulting arms. It described an audit market that “works for the Big Four firms but fails the wider economy”. Incoming CMA chair Andrew Tyrie responded by stating that “something needs to be done” about the Big Four “oligopoly”. MPs also slammed the FRC for “feebleness and timidity” as a watchdog of the audit industry. One confidential industry analysis found that current audit fees fall well short of the amount required to undertake a true quality audit. As a result, accounting firm partners are focused on consulting, which they consider more lucrative and higher status, leaving audit work to overburdened managers and ever-churning pools of junior analysts. Authors concluded that auditors too often have insufficient capacity to understand the company whose accounts they are examining and even less awareness that their real customers are meant to be the shareholders.

Conscious of Kingman and the CMA looking over its institutional shoulder, the FRC has toughened its stance on audit. It released a report hitting auditors for a slide in quality, citing “a failure to challenge management and show appropriate skepticism across their audits.” Further steps are expected. Meanwhile the opposition Labour Party labeled the Big Four a “cartel” and commissioned its own review to consider dismantling it if new elections brought the party to power in Britain.

The industry has responded with proposals such as a cap on the number of large UK firms they can each audit. But calls for a breakup are intensifying rather than easing. So are pleas to reduce the sway of corporate management over outside audits, perhaps by expanding shareholders’ roles in the...
selection, payment, and monitoring of auditors.

Audit chairs in GCC markets may want to watch these developments carefully when they consider whether to retain or replace current auditors since there could be alterations to the universe of outside accounting firm options. Even if UK regulators do not wind up breaking up the Big Four, board members will still be well advised to keep an eye on change. British policy makers might introduce a raft of reforms or fresh best practices for audit firms and industry regulators that could produce mirror rules in other jurisdictions. Even before that happened, international institutional investors might begin exercising stewardship tools to press portfolio company boards in the GCC as to whether their outside auditors abide by new standards. For now, the potential for audit industry change merits a watching brief.

2. What is measured?
Outside audits that audit committees oversee apply standards, techniques, and metrics that are increasingly out of alignment with measurements of value and risk routinely used by shareholders. That is true even though, in theory, the audit is produced for the benefit of investors. Jon Lukomnik, head of Sinclair Capital and a board member, put it this way in an October 2018 speech to CPA Canada. “Intangible assets now make up 84% of the market value of the S&P 500. That’s up from just 17% in 1975. We investors clearly value things like investment in brands, new business processes, skills development for employees, R&D, etc. as drivers of future value. In other words, we believe these investments will create revenues in the future. But accounting can’t figure out how to value those non-tangible assets, so it treats those investments as expenses. That just doesn’t make sense.” And if traditional metrics no longer fully capture value and risk factors for investors, they might be considered equally deficient by corporate executives seeking to manage for long-term performance.

In other words, more stakeholders are asking whether boards in general, and audit committees in particular, are accessories to a process that is growing obsolete by looking at wrong or incomplete indicators.

Since markets naturally seek to adjust for dysfunction, it can be no surprise that there is rising private sector interest in alternative standard setters that try to address variables germane to both corporate leaders and investors. These groups include the Global Reporting Initiative, the Sustainability Accounting Standards Board, and the NGO-backed Alliance for Corporate Transparency. It is equally unsurprising that there is escalating demand for the burgeoning industry of commercial analysis providers, some using big data and artificial intelligence tools, that purport to pick up where conventional accounting standards leave off in order to measure so-called intangibles. These firms sell information both to corporations and to institutions.

The bottom line is that audit chairs and committee members are likely to be under pressure over time to sustain trust in the importance and legitimacy of the audit. This task will be difficult to manage so long as regulators insist on conventional practices by outside auditors. But boards may seek to close the information relevance gap by considering experiments with alternative measurement standards. The objective would be to supplement the traditional audit with an assurance process that provides more insight on company risk both for internal executives and outside stakeholders.

3. What is reported?
Change is coming not only to what is measured in audits, but to how it is reported to investors and others. For decades the garden-variety company annual report has contained a letter from the auditor certifying that the firm’s financial statements have been reviewed and found in compliance with relevant accounting standards. Some jurisdictions have required that an individual, such as the lead audit partner, sign the statement, while others have permitted the letter to simply
state the name of the audit firm. But for the most part the same letter could, with a date change, be inserted into any year’s annual report provided, of course, that the auditor was disclosing no corporate divergences from accepted practice.

At the same time, companies have in recent years begun to supplement audited financial statements with a separate sustainability report to shareholders. Depending on the company, this might be a product also overseen by the audit committee, though the information contained in it is typically not subject to an outside audit. The sustainability report has been designed, by some companies, to offer investors the insights on intangibles that may not be found in financial statements.

Both these practices are now under scrutiny, with change on the way.

First, some jurisdictions, such as the UK, Singapore, and the Netherlands, have prompted a conversion to so-called ‘enhanced’ audit reports. These reports go further than the routine letter to include ‘key audit matters’ (KAMs) observed by the auditor in the course of the audit. The US’s PCAOB is requiring all public companies to include similar, but less expansive, ‘critical audit matters’ as of 2020. These disclosure regimes are each meant to provide investors with pointers as to what risks the auditors found most trenchant in their analysis of the company’s accounts, and how they addressed those risks. Given that it is early days, the quality and depth of enhanced audit reports vary. Some company board audit committees, however, have sought to stand out for excellence in enhanced disclosure. In the UK, for instance, Vodafone (Deloitte) and Rolls-Royce (KPMG) have drawn attention for their fulsome reports by outside auditors. Indeed, the difference between a conventional and enhanced audit report can be striking—even at the same company. In 2016 insurer Aegon released a 16-page enhanced outside audit report to Dutch investors, using Dutch audit reporting standards, and a skimpy, traditional two-pager for US investors, using US audit reporting standards. Scholars are exploring whether enhanced audits have price effects on stock. Whatever the results, early anecdotal evidence is that they may enhance trust and loyalty among shareholders.

The second meta trend in audit reporting is the effort to replace two separate reports, one an audited financial statement and the other a typically unaudited sustainability report, with a single integrated report that combines so-called intangible factors with traditional measures of a company’s condition. The International Integrated Reporting Council is a proponent of such practices. And so are institutional investors such as APG, one of the largest European asset managers, whose CEO once argued that portfolio companies can only be credible asserting their attention to sustainability factors if they find ways to integrate them with financials. This is not easy. Recently, at a Harvard Law School roundtable, an executive at one multinational corporation related how the firm had progressed on integration but neglected to include any sustainability factors in its periodic calls with investors—until those investors pointed out the anomaly. But Japan, in particular, has taken the lead in embracing integrated reporting. In 2017 some 341 corporations adopted the practice.

As enhanced audit and integrated reporting spread, GCC board audit committees may find value in monitoring how pacesetting companies handle the new disclosure techniques. They may even urge their companies and auditors to run tests to see how they might be adapted. Advantages could come in the form of higher confidence among investors, with the prospect of a lower cost of capital, and better internal management of multiplying risks that fall outside the bounds of conventional accounting standards.