

Audit chairs discuss Brexit, accounting standards, and information security

At its 14–15 November meeting in London, the European Audit Committee Leadership Network (EACLN) hosted the chair of the International Accounting Standards Board (IASB) for a discussion on accounting standards. Members also discussed the role of the chief information security officer (CISO), the current state of Brexit, and new developments in fraud detection.¹

Members discuss the future of accounting standards with the IASB

Overseeing financial reporting is a core duty of an audit committee, and EACLN members are interested in recent changes to international accounting standards. Hans Hoogervorst, chair of the IASB, joined members to discuss the impact of the new international financial reporting standards (IFRS), the potential for convergence with US generally accepted accounting practices (GAAP), and the future direction of financial reporting.

Mr. Hoogervorst noted that IFRS has been widely adopted throughout Europe and Asia, most recently in emerging markets such as India and China. *“It is amazing that IFRS is now the most widely used economic standard around the world,”* he said. The United States remains committed to US GAAP, and members asked about the potential for the two standards to converge. Mr. Hoogervorst described recent, intensive efforts: *“Revenue recognition was fully convergent, and we converged on lease accounting. But on financial instruments (IFRS 9) we failed to converge, nor did we converge on insurance accounting. The only road to full convergence would be US adoption of IFRS. I don’t see that happening in the near future.”*

The IASB has been active over the past few years and has released four major new standards. A member asked, *“How does the IASB try to balance the resources that issuers need to comply with new standards against the system-wide benefits of the standards?”*

Mr. Hoogervorst said that the IASB is constantly consulting stakeholders on these concerns: *“Usually we know whether individual standards will be costly to implement.”* He admitted that *“it’s impossible to quantify precisely the benefits of new standards, besides assuming the benefit to capital markets generally.”*

Mr. Hoogervorst indicated that, after the recent period of significant change, the pace of standard setting will now slow: *“We have to back off and let companies digest what we’ve done. We can’t have constant change. We have filled the biggest gaps and need to give the system time to implement the new standards.”* He also suggested that the IASB may perform a post-implementation review of the new standards. *“It would be good for us to look at the standards after three years and measure their success and costs of*

implementation. We need quantitative data from business to show us the cost of implementing a standard like revenue recognition,” he said.

Members explored future directions for accounting standards with Mr. Hoogervorst. One asked whether the IASB would consider industry-specific reporting standards similar to what is available in the United States. Mr. Hoogervorst said, *“We would still like for standards to remain industry agnostic,”* but described recent exceptions in insurance and banking. He also mentioned that the IASB is working on a few other industry-specific standards, such as in the extractive industries, and added that the IASB could provide non-mandatory guidance on industry-specific income statement items: *“We know that non-GAAP measures are there to fill in that industry-specific information. And that’s why not all non-GAAP reporting is bad.”*

Mr. Hoogervorst and members discussed ways to improve the quality of non-GAAP measures. Mr. Hoogervorst said, *“We could provide more discipline or require evidence about when an adjustment is infrequent.”* The IASB is also considering standard definitions of certain subtotals on the income statement, such as earnings before interest and taxes. But Mr. Hoogervorst made it clear that the IASB would not create environmental, sustainability, and governance standards: *“We will not delve into sustainability reporting. It is not our expertise.”*

Mr. Hoogervorst urged members to review non-GAAP measures carefully, especially those used in executive remuneration. *“As audit committee chairs, you have to be on top of these measures. The alternative performance measures used for executive remuneration tend to filter out everything adverse. This leads to situations where management compensation goes up, even during a downturn.”* Members emphasized the audit committee’s role in overseeing non-GAAP performance measures. *“Alternative performance measures should be aligned to how the board wants to evaluate strategy and performance. I think the audit committee ensures that these metrics are clear, well defined, consistent, and reconciled to underlying statutory accounts,”* one member stated. Another added, *“We spend as much time reviewing non-GAAP measures as we do reviewing GAAP measures.”*

CISOs share perspectives on their evolving role

In most organizations, the CISO communicates directly with the audit committee and the board about cybersecurity, which remains a top concern for companies and their boards. Members were joined by Robert Coles, CISO and head of information protection for GSK; Emma Smith, group technology security director for Vodafone; and EY’s Mike Maddison, partner for EMEIA Advisory Servicesⁱⁱ, to discuss the evolving role of the CISO and ways that audit committees can effectively engage with top information security executives.

Mr. Maddison observed that in the past, the CISO, if one existed, was a gatekeeper, focused on technical and compliance matters. But the scope of the role, the profile of the executive, and the level of responsibility have all changed. For example, Dr. Coles has

overall responsibility for security at GSK, and he leads on issues including security policy and third-party oversight. Ms. Smith leads both first-line defenses—functional elements of the cybersecurity platform—and second line: information security policy and oversight. One member asked whether CISOs should generally be separate from their IT organizations. Neither Dr. Coles nor Ms. Smith thought that this was essential; both indicated that direct access to the CEO and board were more important than formal reporting lines.

Another member said that one important aspect of information security is mobilizing employees to learn about, keep in mind, and comply with cybersecurity practices. The guests agreed that the human resources (HR) organization often works closely with the CISO on these behavioral issues. As physical and digital security converge, measures that can fall within the HR remit, like access rights to premises, background checks, and user identities, become critical to overall security. But Dr. Coles and Ms. Smith both expressed caution about appointing CISOs who understand people issues but lack deep technical expertise. Ms. Smith observed that *“the risk of having someone non-technical in the CISO role is that they may not have enough technical knowledge to make quick decisions.”*

Members explored ways to improve the effectiveness and efficiency of director interactions with CISOs. While members said they cover cybersecurity in every audit committee meeting, some expressed frustration with how it is handled. One said, *“I’m seeking a method out of madness. We have too many presentations on cyber. It seems that we’re constantly talking about random occurrences. Is there a framework that is comprehensive, so that we know we’re not missing elements?”* Another asked, *“How can I make sure that we’re doing enough?”*

Ms. Smith described her approach with the Vodafone board and audit committee: *“I start with international standard frameworks and highlight key controls for our organization. We identify key risks and map the controls to those risks. This creates a common language and a common set of risks. I then measure and report on how effective we are in working on these controls and risks—a controls effectiveness score. I profile those risks into a program and budget.”* Dr. Coles agreed with starting with an international standard, but he focuses on benchmarking his organization to show the board where the company stands in relationship to its peers. *“I show risk reduction and impact and concentrate on both where we care today and where we need to get to,”* he said.

Ms. Smith added, *“I’d ask to see a crisis response plan if I were on an audit committee. Everyone needs to know who has authority to make decisions, particularly in the first hours. We tested this through scenario planning.”* Mr. Maddison noted that simulations *“are hugely insightful, as it helps management learn how they would react.”* One member described a cyberattack simulation involving senior management: *“It was chaos. Senior management had no idea what to do. A huge range of issues emerged, and we saw the gaps.”*

The guests shared views on the most significant sources of cyber risk large companies face. There was consensus that nation-state actors pose the most serious risk to companies, particularly those that are well known. There was also agreement on the importance of security hygiene—applying security patches and updates to legacy systems. One attendee observed, *“Everyone is very nervous of service outages, so patching can be delayed. Patching is often seen as routine and doesn’t get the attention it deserves. But companies need to make bold decisions.”* Dr. Coles agreed: *“We used to do major testing of patches, but that takes time. Now, we test patches over a smaller sample size and take some risks.”*

“Brexit is going to happen,” Lord Hill tells members

In a lively discussion with Lord Jonathan Hill, recently European Union (EU) commissioner for financial services, members questioned whether the United Kingdom would truly leave the EU. *“Brexit is going to happen, even after the botched general election, and everyone needs to plan accordingly,”* insisted Lord Hill. *“I was just as surprised as all of you by the result. Within the EU, there was an initial sense of shock, sadness, and a sense of fragility that the UK was the first brick out of the wall. The EU was very nervous and hopeful that the UK would come back in. Since then, the mood has shifted. Europe is seeing strong growth rates as the UK stagnates. Fears of populists in the Netherlands, France, and Austria have subsided. Now the EU’s attitude simply is ‘Get on with it.’”* Lord Hill explained that the leadership of the two main political parties are committed to leaving the EU: *“Both the Tory and Labour leadership want to leave. Labour has talked about introducing capital controls. It will want to subsidize nationalized industries. It doesn’t want the free movement of people, because immigration is not popular in its traditional seats. If the UK were to remain in the EU, it wouldn’t have a free hand with any of those policies.”*

Lord Hill speculated that the United Kingdom might remain part of the customs union, but doubted that it would remain in the Single Market. He anticipates that new EU policies will be put in place following the departure of the United Kingdom from the EU that would be likely to make staying in the Single Market less attractive: *“Without the UK, financial services legislation in the EU is probably going to move in a direction that UK businesses aren’t comfortable with. The UK could establish some of its own approaches to regulation that are more forward looking and don’t follow the EU. There could be a choice: whether to go for a model that mimics the EU legislation, allowing EU supervision and oversight (which the EU would insist on), or to diverge from the EU regulatory scheme and remain outside the Single Market. I think we have to look seriously at the latter.”* Lord Hill suggested that without the United Kingdom in the EU, other countries will have to step up and lead on financial regulation and become more outward looking. *“One commissioner said, ‘For a long time, Britain has been the soloist on markets and regulation. Now, other countries will have to lead the choir.’”*

Data analytics unlocks new ways to uncover fraudulent activities and predict bad behavior

In three demonstrations, EY's Maryam Hussain, Carl Judge, and Glenn Perachio showed how organizations are using a wide range of structured and unstructured data to pinpoint fraud. Use of data analytics has grown from analyzing historical data to drawing on real-time readings of individual behavior. Today, it is not only possible to identify areas of potential risk but also to predict problematic employee behavior at a highly granular level.

Ms. Hussain advised members to ask management, *“What is the one thing that would be catastrophic for your organization?”* Then see how management is putting controls in place for that event. Then ask, *‘How could those controls be circumvented, and how can you control for that risk?’*

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Appendix: Participants

Members participating in all or part of the meeting sit on the boards of over 50 public companies:

Mr. Aldo Cardoso, ENGIE

Ms. Carolyn Dittmeier, Generali

Mr. Ángel Duráñez, Repsol

Mr. Eric Elzvik, Ericsson

Mr. Byron Grote, Tesco, Akzo Nobel and Anglo American

Ms. Siân Herbert-Jones, Air Liquide

Mr. Lou Hughes, ABB

Mr. Arne Karlsson, Mærsk

Ms. Dagmar Kollmann, Deutsche Telekom

Mr. Richard Meddings, Deutsche Bank

Mr. Nasser Munjee, Tata Motors

Ms. Guylaine Saucier, Wendel

Mr. François Thomazeau, Bolloré

Ms. Martine Verluyten, STMicroelectronics and Thomas Cook

Mr. Lars Westerberg, Volvo

EY was represented in all or parts of the meeting by:

Mr. Jean-Yves Jégourel, EMEIA Assurance Leader

Mr. Hywel Ball, Managing Partner, Assurance, United Kingdom & Ireland

Endnotes

ⁱ The network is a group of audit committee chairs from Europe's leading companies (typically with revenues exceeding €8 billion) who are committed to improving audit committee performance and enhancing trust in financial markets. It is organized and led by Tapestry Networks with the support of EY as part of its continuing commitment to board effectiveness and good governance. *Summary of Themes* is produced to stimulate timely, substantive board discussion as audit committee members, management, and their advisers endeavor to fulfill their responsibilities to the public. This document reflects the network's use of a modified version of the Chatham House Rule whereby names of members and their company affiliations are a matter of public record, but comments are not attributed to individuals or corporations. Italicized quotations reflect comments made in connection with the meeting by network members and other meeting participants. The guests have permitted their comments to be attributed.

ⁱⁱ EMEIA stands for "Europe, the Middle East, India, and Africa."