2017 Private Company Audit Committee Outlook

What's on your audit committee agenda?

Private company audit committees have full agendas and finite resources, which can make keeping abreast of certain items a challenge. This is particularly so in these times of ongoing disruption and increasing risks — risks that audit committees are responsible for overseeing.

Grant Thornton LLP has identified a number of items for audit committees in private companies to consider during the course of 2017. While specific issues will vary depending on the organization and its governance structure, industry, geographical scope and regulatory environment, we believe the following areas could have a potentially significant impact on private companies in the upcoming year and beyond.

A bit of background

Audit committees in private companies are characterized by various levels of engagement. Some mainly review the financial reports; others review financial reports and actively advise the board on risks and other matters. Private company audit committees also range from informal to formal. Those in the latter group generally have a charter, hold regularly scheduled meetings, and fulfill explicit governance and risk-oversight responsibilities.

Levels of engagement and formality, as well as the actual governance and oversight functions, often but not always correspond to company size, industry, regulatory environment, geographical scope and ownership structure. For example, large companies in highly regulated industries with international operations and third-party investors, such as private equity firms, will tend to have more formal audit committees. Companies with the opposite of that profile may not have designated formal audit committees, and instead may have the full boards fulfill the review and risk oversight responsibilities that audit committees would typically execute.

The importance and urgency of the following potential agenda items will vary for a given organization. Some may be long-standing concerns that are becoming urgent, while others may arise from changes in the business, risk or regulatory environment. However, each of these items is at least worth considering in these times of disruptive change.

ITEM 1. Adjusting to potential policy and economic changes

The election of Donald Trump to the U.S. presidency, with a stated focus on dramatic change, signals a potentially major shift in regulatory and economic policies affecting businesses. Forecasting the likely impact of a new administration is always difficult, and even more so with an administration led by a president who values unpredictability.

Potentially major changes in policies affecting taxes, trade, labor, international relations and regulatory priorities could pose risks, as well as opportunities. The audit committee should evaluate whether management has considered and adequately addressed the potential risks associated with policy and economic changes that may affect the business and competitive landscape.

Key items to consider might include:

- Impact on trade and overseas assets, particularly with regard to Mexico and China, and likely changes in tariffs and customs and border controls; companies with international supply chains or markets should develop contingency plans and closely monitor developments.
- Impact of changes in immigration policies on labor availability, practices and costs, including the potential for labor shortages, heightened regulatory scrutiny and increased expenses.
- Impact of likely fiscal and monetary policy, including infrastructure spending (which could create opportunities and stimulate job growth) and tighter Federal Reserve policy (which could increase interest rates).
- Impact of tax policy, particularly for companies with large sums overseas, in which case repatriation at lower tax rates could create a need for new distribution policies and investment strategies.
- Impact on specific industries such as oil and gas, construction, shipping and transportation, financial services, technology, life sciences and health care, and real estate, particularly in the area of potential deregulation.

Consider potential impacts on customers and suppliers, as well as on the organization itself. Also, bear in mind that while some policies, such as those enacted by executive order or adjustments to agency priorities, can be changed relatively quickly, others can take months or even years to alter or unwind.

The goal is not to try to precisely predict impacts — an impossibility — but rather to forecast a range of impacts on the organization and their effects on performance and value. Then management can develop strategies, with board input, that enable the company to adjust so as to enhance performance, and protect and create value.

Item 2. Addressing regulatory issues and accounting changes

Audit committees must ensure their organizations are prepared to comply with domestic and foreign regulations and professional standards related to financial reporting. This requires a governance infrastructure with mechanisms that ascertain that the organization has documented policies and procedures for adhering to regulatory mandates, and that it can demonstrate compliance. Proper training and controls are also required, as are methods of monitoring regulatory change.

For example, U.S. organizations with international operations may be subject to provisions of the Foreign Corrupt Practices Act and similar legislation in other countries, such as the UK Bribery Act. In addition to regulatory issues, private companies can, like their publicly held peers, risk operational disruption or reputational damage over labor practices or product content issues.

Regarding accounting changes, requirements in two areas — revenue recognition and accounting for leases — will affect all companies in the next two to three years.

Changes in the revenue recognition standard go into effect for nonpublic companies on Jan. 1, 2019. The experience to date indicates that many companies that initially did not think they would be affected (other than through some additional disclosures) are now determining that their recognition practices are not consistent with the new standard. It is imperative for audit committees to ascertain whether the company is preparing for adoption of the standard.

Given that the new standard will affect organizations differently, the audit committee should:

- Understand management's assessment of the impact of the standard on policies, procedures, operations and financial statements; specifically, the new standard may affect debt covenants, compensation programs and sales contracts as well as other areas.
- Ascertain that the right people are included in the implementation effort; Grant Thornton recommends a cross-functional team with representatives from accounting, tax, IT, legal, sales and compensation. Internal audit should be party to these discussions as well.
- Provide oversight on management's accounting judgments, particularly where management will be increasing the use of estimates, which may be the case given the more principles-based approach of the new standard.
- Support requests for required additional resources, such as new or enhanced accounting processes or increased internal audit resources.

Well before adoption, the audit committee should understand the implications of the new revenue recognition standard, management's plans for implementation and likely required resources.

Considerations regarding leases will arise in the run-up to 2020, when the new lease accounting standard takes effect. That standard will bring most leases onto the balance sheet of most lessees, and generate impacts for lessees and lessors. Key considerations for most companies will include management, centralization and policy changes regarding leases. In addition, loan ratios may be affected and potentially have an impact on debt covenants.

As with the changes to the revenue recognition standard, the sooner the organization begins to understand the effects and prepare to address them, the better.

Item 3. Overseeing cyberrisk

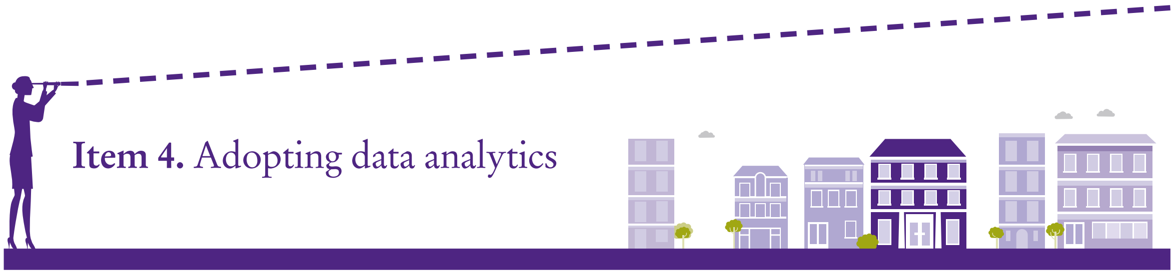
Given the proliferation of cybercrime, cyberrisk oversight is an ongoing concern for audit committees. Challenges are specific to industries, companies, technologies and processes, but in general an organization's rate of technology adoption can easily outpace its ability to manage the associated risks. These include risks to intellectual property, customer data and sensitive internal data, including data on senior executives and board members. The near inevitability of a breach also demands a clear and practical cyberincident response plan.

One very useful oversight activity would be for the audit committee or board to ask management to develop a plan to assess all digital assets and the risks to those assets and then, based on those assessments, to prepare plans for monitoring, mitigating and addressing cyberrisks.

Once those steps have been taken, an audit committee would consider engaging internal audit (or a third-party resource) to conduct an objective review of the cyberrisk management program. If internal audit lacks the requisite skills, they can be acquired though co-sourcing or bringing in specialists.

Companies that depend on business models enabled by technology or on cybercapabilities for core processes would do well to recruit a (preferably external) board or audit committee member with experience and knowledge of IT and/or cyberrisk management. That person can lend an objective view to reports from the CTO, CIO or CISO — and help other board or audit committee members understand the impact and likelihood of cyberrisk events.

Again, depending on the role of IT in the organization, having security, mitigation and response plans in place may represent table stakes. Having internal audit review those plans — preferably against peer benchmarks or leading practices — and provide objective assurance regarding those plans to the audit committee and board would be steps worth considering.



Item 4. Adopting data analytics

Data analytics can improve the quality of reporting on financial and operational systems and controls, and help an audit committee better understand risks and opportunities.

Improved reporting quality results from the ability to monitor entire data sets of transactions and accounts. Capture and analysis of all data on, say, a population (rather than sample) of receipts, payments, deliveries or warranty claims can identify revenue and cash leaks (such as unauthorized discounts taken by customers on invoices or bogus warranty claims), as well as anomalies and outliers that point to process weaknesses or control breakdowns.

Better understanding of risks and opportunities results from insights that management and internal audit can provide when disparate data sets are aggregated and analyzed. Factors driving inventory shrinkage; employee turnover; customer loyalty; and credit, fraud and other risks can be isolated, analyzed and better understood and managed.

The following factors can help an audit committee make the case for data analytics in accounting/finance, internal audit and other key areas:

- Both the cost and the complexity of related tools have decreased in recent years, making them far more accessible and practical.
- Monitoring or analysis of populations of transactions or accounts can enable management to leverage existing data to provide enhanced reporting and analysis.
- Monitoring or analysis of populations of transactions or accounts can also enable internal audit to scope and execute audits more efficiently, and provide higher levels of assurance to the audit committee and the board.
- Internal audit can, with audit committee support, foster adoption of data analytics in the organization by demonstrating benefits in pilot programs that identify process inefficiencies, cash leaks and missing revenue.

Also, while cleaning, extracting and aggregating data present challenges, the audit committee can provide leadership for the organization to address those challenges — and point out that waiting for perfect data is not a practical approach.

Regarding the latter point, costs, time constraints and lack of skills often deter organizations from adopting data analytics. However, these factors should be weighed against the benefits. The costs and time involved in adopting new processes and tools are often offset by efficiencies achieved. Lack of skills can be addressed through hiring, co-sourcing and outsourcing, or by developing guest auditor, rotational or training programs.

Grant Thornton sees private companies' data analytics capabilities as being about where cyberrisk management stood five or six years ago. As was the case with cyberrisk management, companies that move to adopt data analytics before their peers can gain experience, benefits and marketplace advantages before less forward-thinking competitors.

Item 5. Coping with intergenerational shifts

The baby-boom generation will be one year older in 2017, and that's the point. While the World War II generation has largely left the private company stage, at least as active managers, baby boomers (born 1946–1964) continue what has been a slow transfer of power. Reluctance to yield active management and decision-making to the next generation can create tension in private companies, which often lack rigorous succession plans.

While mainly a board and CEO matter, management succession planning, intergenerational shifts and next-generation readiness (or lack thereof) can create issues that should make their way onto audit committee agendas.

For example, key tasks for the audit committee would include:

- Gauging the risks that attend transfer of ownership and management to the next generation, and those of not preparing the next generation to assume responsibilities
- Understanding the succession plan that transfers ownership, with an eye toward how the plan minimizes risks, optimizes value and safeguards company assets
- Adjusting the company's risk appetite to reflect factors such as next-generation readiness, and the timing of investments in controls and organizational governance

Tensions can arise among family members when younger owners and managers want to take a family-held company in a new direction, invest in new technology or expand internationally, and older owners and managers resist. Risks arising related to family conflicts may not be adequately addressed, and lead to significant losses in value and opportunities.

Given its risk oversight role, the audit committee should advise the board on risks associated with generational and succession issues. Ownership, management and the board can then work within the organization to address these issues through leading practices in succession planning and implementation.

Item 6. Targeting the right level of governance

As noted, audit committee engagement and practices vary widely among nonpublic companies. Yet the need for audit committees to gauge and articulate the appropriate level of governance and risk oversight for the organization, and to assist in developing and maintaining it, exists across all companies.

The appropriate level of governance and oversight will depend on several factors, notably the ownership structure and, if applicable, the exit strategy. If the latter were to include a potential public offering or sale to a company with rigorous due diligence, there may be a need for enhanced governance.

Ownership structures that include employee ownership (for example through an employee stock ownership plan (ESOP), private equity ownership, or other owners external to a family or partnership) may have different areas of focus. For example, an investment company that holds customer assets will have a different profile from a manufacturer or distributor. The audit committee should evaluate where they will focus their oversight activities accordingly.

The audit committee might also consider a framework for risk management and controls, such as the Committee of Sponsoring Organizations (COSO) framework, as a source of guidance, and consider promulgating controls that make sense given the likely costs and benefits. The costs include the investment in developing controls and the expense of maintaining them. Adding controls will also usually add steps to processes like making purchases, paying invoices and closing deals, which can decrease agility and speed, at least initially. However, benefits include enhanced processes, governance, risk management and reporting.

Factors to consider in targeting the appropriate level of governance include:

- The level of operating and reporting systems needed to support growth; attract private investors; or prepare the organization for succession, sale or IPO.
- The expectations of customers and potential partners, and the due diligence that external stakeholders may exercise.
- The actual costs and benefits for the company and its stakeholders rather than vague ideas or general arguments; in many private companies, factions argue for and against enhancements to governance without basic facts that a bit of research could provide.
- The appearances that inadequate governance and risk management can create; for example, while it may not make business sense to spend one million dollars to prevent a half million dollar loss to fraud, it can be difficult to explain to stakeholders, particularly to ESOP participants or external owners, why management did not do more to prevent fraud of any magnitude.

It can be frustrating for a dedicated board or audit committee member to make the case for greater governance in a privately held business. The key, however, is to urge owners to collaborate with the board to get to the right decision consciously and explicitly, on the basis of research and analysis, and to revisit the decision periodically as the organization grows and changes.

Toward enhanced governance and risk oversight

Virtually every aspect of the business environment can now be characterized as disruptive, challenging and unpredictable. In their role as overseers of risk, audit committees can interact with management, the board and the internal audit function to develop the capabilities needed to not only protect assets, but also to boost performance and enhance value in this environment.

Companies that manage the risks that they can control, such as those regarding intergenerational shifts and regulatory compliance, will be better prepared to focus on those more outside their control, such as economic and marketplace change, and thus enhance their competitive advantage.

For audit committees, boards and executive teams in private companies, getting governance and risk oversight right stands among the major challenges in 2017 — and for the foreseeable future.

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