

# On the 2023 audit committee agenda

KPMG Board Leadership Centre

The business and risk environment has changed dramatically over the past year, with greater geopolitical instability, surging inflation, and the prospect of a global recession now added to the mix of macroeconomic risks companies are facing in 2023. Audit committees can expect their company's financial reporting, compliance, risk and internal control environment to be put to the test by an array of challenges in the year ahead – from global economic volatility and the war in Ukraine to supply chain disruptions, cybersecurity risks and ransomware attacks, and social risks – including the tight talent market. To be sure, the increasing complexity and fusion of risks unfolding simultaneously, and the unexpected interconnectedness of these risks, will put a premium on more-holistic risk management and oversight.

In this volatile and opaque operating environment, demands by regulators, investors, and other stakeholders for more action and greater disclosure and transparency – particularly around the company's climate and other environmental, social, and governance (ESG) risks – will continue to intensify.

Drawing on insights from our interactions with audit committees and business leaders, we've highlighted nine issues to keep in mind as audit committees consider and carry out their 2023 agendas

## 1. STAY FOCUSED ON FINANCIAL REPORTING AND RELATED INTERNAL CONTROL RISKS – JOB NUMBER ONE

Focusing on the financial reporting, accounting, and disclosure obligations posed by the current geopolitical, macroeconomic, and risk landscape – including the Russia-Ukraine war, supply chain disruptions, cybersecurity, inflation, interest rates, market volatility, and risk of a global recession – will be a top priority and major undertaking for audit committees in 2023. Key areas of focus for the annual report and accounts should include:

### **Making tough calls: Forecasting and disclosures**

The uncertainties posed by the current geopolitical, macroeconomic, and risk

landscape, coupled with the extensive use of forward-looking information in financial statements, continue to make disclosures about matters

that directly or indirectly impact the company's business a top area of focus. Matters requiring the audit committee's attention might include:

- Disclosures regarding the impact of the Russia- Ukraine war and sanctions, supply chain disruptions, heightened cybersecurity risk, inflation, interest rates, market volatility, and the risk of a global recession
- Preparation of forward-looking cash-flow estimates; impairment of nonfinancial assets, including goodwill and other intangible assets
- Accounting for financial assets (fair value)

- Going concern and the longer-term viability statement. The volatile economic environment and its impact on (say) cashflows, credit lines and borrowing facilities, has driven many organisations to double down on scenario planning and impact analysis
- The use of non-GAAP metrics, including ESG metrics

With companies making more tough calls in the current environment, regulators are emphasising the importance of well-reasoned judgments and transparency, including contemporaneous documentation to demonstrate that the company applied a rigorous process. Given the fluid nature of the long-term environment, disclosure of changes in judgments, estimates, and controls may be required more frequently.

### Internal control over financial reporting and probing control deficiencies

Given the continuing impact of the Russia-Ukraine war, supply chain disruptions, the risks and uncertainties posed by the broader geopolitical, macroeconomic, and risk landscape – as well as the proposals to introduce a stronger framework for internal controls via the UK Corporate Governance Code (see later) – internal controls will continue to be put to the test in the coming year with many looking at what ‘no regret’ actions can be taken to strengthen existing frameworks including the identification, assessment and control of fraud risk.

Audit committees should discuss with management how these matters affect management’s disclosure controls and procedures and management’s assessment of the effectiveness of internal control over financial reporting.

When control deficiencies are identified, it’s important to probe beyond management’s explanation for “why it’s not a disclosable significant failing or weakness” and help provide a balanced evaluation of the deficiency’s severity and cause. Is the audit committee – with management – regularly taking a fresh look at the company’s control

environment? Have controls kept pace with the company’s operations, business model, and changing risk profile, including cybersecurity risks? Does management talk the talk *and* walk the walk?

Audit committee members continue to express concern that overseeing major risks on the audit committee’s agenda – beyond its core oversight responsibilities (financial reporting and related internal controls, and internal and external auditors) – is increasingly difficult. Demands for expanded disclosures regarding a range of ESG and sustainability risks have heightened concerns about audit committee bandwidth and “overload.”

Reassess whether the committee has the time and expertise to oversee these other major risks. Do cybersecurity, climate, ESG, and “mission-critical” risks such as safety require more attention at the full-board level – or perhaps the focus of a separate board committee? The pros and cons of creating an additional committee should be weighed carefully; but considering whether a finance, technology, risk, sustainability, or other committee – and perhaps the need for directors with new skill sets – would improve the board’s effectiveness can be a healthy part of the risk oversight discussion.

## 2. CLARIFY THE ROLE OF THE AUDIT COMMITTEE IN OVERSEEING THE COMPANY’S ESG RISKS

Intensifying demands for higher quality ESG disclosures should be prompting boards to reassess their oversight structure relating to ESG risks and disclosures. As investors, regulators, ESG rating firms, and other stakeholders seek ESG information that is decision-useful, accurate, and comparable, clarifying the role and responsibilities of the audit committee should be a priority.

Boards are taking various approaches to overseeing climate and other ESG risks. For many, that oversight is a full-board function, with much of the heavy lifting done at the committee

level. ESG committees are becoming an increasingly common presence on FTSE 100 boards, but the audit, remuneration, and nomination committees all may have some responsibility. For example, the remuneration committee will likely oversee any ESG related performance incentives, while the nomination committee will be concerned to ensure the right skills and experience are in place around the boardroom table and on the senior management team.

The audit committee typically has responsibility to oversee ESG disclosures and disclosure frameworks, financial risks, the expanding legal/regulatory compliance risks, data and perhaps the robustness of the company’s ERM processes more generally.

With board standing committees playing such a vital role in helping boards carry out their oversight responsibilities related to ESG risks (as well as broader strategic issues such as the ability of an organisation to raise finance), there is a premium on information sharing and communication and coordination among committees so that the full board and the committees have important information they need for their ESG oversight. From the audit committee’s perspective, given the financial reporting and internal control implications associated with ESG risks, the issue is particularly acute; audit committees need to recognise the types of input that other committees require from the audit committee, and these other committees must appreciate the information needs of the audit committee. Key areas in which information sharing is critical include:

- Considering where ESG disclosures should be made – e.g., the Strategic Report, financial statements, any sustainability reports, and/or the company’s website.
- Helping to ensure that ESG information being disclosed is subject to the same level of rigor as financial information – meaning disclosure controls and procedures.
- Selection of an ESG reporting framework(s).

### 3. KEEP ABREAST OF THE AUDIT REFORM AGENDA AND ENCOURAGE MANAGEMENT TO TAKE ANY NECESSARY 'NO REGRET' ACTIONS

Pay close attention to the audit reform agenda – in particular the proposals to introduce, via the UK Corporate Governance Code, a stronger framework for internal control reporting.

However the proposals are implemented, there will be a huge amount for audit committees to think about and prepare for. What 'no regret' actions can organisations take now to ensure a smooth transition to any new framework? How will you oversee any necessary cultural shift? Are the benefits of any changes clearly articulated? How can technology be best leveraged? Is there agreement as to the organisation's principal risks starting with the key risks with a financial statement impact? If you don't know where your principal risks are you will end up with the wrong control environment.

Beyond internal controls over financial reporting, consider how the audit committee (and board) will respond to the calls for:

- New disclosures around business resilience, fraud and distributable profits for companies with turnover in excess of £750 million and more than 750 employees (750:750PIEs)
- New minimum Standards for FTSE350 audit committees
- A triennial Audit and Assurance Policy for 750:750 PIEs setting out the board's approach to seeking assurance – internal and external – on the information reported to shareholders
- A new regulatory regime where all relevant directors will be held to account for breaches of their financial reporting and audit duties – not just those who are members of professional accounting bodies

- The introduction of managed shared audits to increase competition within the FTSE350 audit market.

Also, be cognizant of the recent changes to the IESBA Code of Ethics which now treats all listed entities as PIEs as well as introducing an overarching prohibition for NAS provided to IESBA PIEs that may create a self-review threat. Audit committees of impacted organisations will need to consider their audit strategy, NAS policy and pre-approval arrangements.

### 4. MAINTAIN A SHARP FOCUS ON LEADERSHIP AND TALENT IN THE FINANCE ORGANISATION

Finance organisations face a challenging environment today – addressing talent shortages, while at the same time managing digital strategies and transformations and developing robust systems and procedures to collect and maintain high-quality ESG data both to meet investor and other stakeholder demands. Many are contending with difficulties in forecasting and planning for an uncertain environment, and working with the workforce to ensure they remain motivated and engaged is becoming harder.

As audit committees monitor and help guide finance's progress in these areas, we suggest two areas of focus:

- Many finance organisations have been assembling or expanding management teams or committees charged with managing a range of ESG activities, including enhancing controls over the ESG information being disclosed in corporate reports. Does the finance organisation have the leadership, talent, skill sets, and other resources necessary to address climate and other ESG reporting and to ensure that quality data is being collected and maintained? Has adequate consideration been given to the diversity of the team and the pipeline? How far along is the finance organisation in its preparations for any new/enhanced ESG disclosures?

- The acceleration of digital strategies and transformations that many companies are undertaking continues to affect finance organisations, presenting important opportunities for finance to reinvent itself and add greater value to the business. And 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. Is finance attracting, developing, and retaining the talent and skills necessary to match its evolving needs?

It is essential that the audit committee devote adequate time to understand finance's ESG reporting and digital transformation strategies and help ensure that finance has the leadership, talent, and bench strength to execute those strategies.

### 5. REINFORCE AUDIT QUALITY AND SET EXPECTATIONS FOR COMMUNICATIONS WITH THE EXTERNAL AUDITOR

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 setting expectations of the external auditor for 2023, audit committees should discuss with the auditor what worked well in 2022, and the opportunities for improving audit quality in 2023? What complexity does hybrid or remote work add to the audit? How have the company's financial reporting and related internal control risks changed in 2023 in light of the geopolitical, macroeconomic, and risk landscape – including the Russia-Ukraine war, supply chain disruptions, cybersecurity, inflation, interest rates, market volatility, climate change and other ESG issues, changes in the business, and the risk of a global recession? What are the auditor's plans

to keep the 2023 audit and the 2023 interim reviews on track?

Set clear expectations for frequent, open, candid communications between the auditor and the audit committee – beyond what’s required. The list of required communications is extensive, and includes matters about the auditor’s independence, as well as matters related to the planning and results of the audit. Taking the conversation beyond what’s required can enhance the audit committee’s oversight, particularly regarding the company’s culture, tone at the top, and the quality of talent in the finance organisation.

Audit committees should also 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. In discussions with the external auditor regarding the firm’s internal quality control system, consider the results of recent regulatory inspections and internal inspections and efforts to address deficiencies. Remember that audit quality is a team effort, requiring the commitment and engagement of everyone involved in the process – the auditor, audit committee, internal audit, and management.

Looking more widely, ask are we ‘doing the right thing?’ Many companies are thinking about how they are perceived by shareholders and other stakeholders and this – coupled with the proposals for an Audit and Assurance Policy (see above) – is empowering some audit committees to extend the independent (external) assurance they receive whether that by from the external auditor or other third party assurance providers.

## 6. MAKE SURE INTERNAL AUDIT IS FOCUSED ON THE COMPANY’S KEY RISKS – AND IS A VALUABLE RESOURCE FOR THE AUDIT COMMITTEE

At a time when audit committees are wrestling with heavy agendas – and issues like ESG, supply chain

disruptions, cybersecurity and data governance, and global compliance are putting risk management to the test – internal audit should be a valuable resource for the audit committee and a crucial voice on risk and control matters.

Finally, be cognisant of the capacity constraints within the audit profession. Think ahead if an audit tender is due or planned – getting the ‘right’ auditor may be more difficult than expected.

This means focusing not just on financial reporting and compliance risks, but on critical operational and technology risks and related controls, as well as a range of ESG risks.

ESG risks are rapidly evolving and include human capital management – from diversity, equity, and inclusion (DEI), to talent, leadership, and corporate culture – to climate, cybersecurity and data governance and privacy, as well as the risks associated with the company’s disclosures regarding ESG. Disclosure controls and procedures and internal controls should be a key area of internal audit focus. Clarify internal audit’s role in connection with ESG risks and ERM more generally – which is not to manage risk, but to provide added assurance regarding the adequacy of risk management processes. With the tight labour market and the Great Resignation, does the finance organisation have the talent it needs? Do management teams working on new climate and ESG initiatives have the necessary resources and skill sets? Recognise that internal audit is not immune to these talent pressures.

Given the evolving geopolitical, macroeconomic, and risk landscape, reassess whether the internal audit plan is risk-based and flexible – and can adjust to changing business and risk conditions. Going forward, the audit committee should work with the chief audit executive and chief risk officer to help identify the critical risks – such as tone at the top and culture, legal/regulatory compliance, incentive structures, cybersecurity and data privacy, ESG risks, and global supply chain, outsourcing, and third party

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 key risks and related controls.

- What’s changed in the operating environment?
- What are the risks posed by the company’s digital transformation and by the company’s extended organisation – sourcing, outsourcing, sales, and distribution channels?
- Is the company sensitive to early warning signs regarding safety, product quality, and compliance?
- What role should internal audit play in auditing the culture of the company?

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.

## 7. HELP SHARPEN THE COMPANY’S FOCUS ON ETHICS, COMPLIANCE, AND CULTURE

The reputational costs of an ethics or compliance failure are higher than ever, particularly given increased fraud risk, pressures on management to meet financial targets, and increased vulnerability to cyberattacks.

Fundamental to an effective compliance program is the right tone at the top and culture throughout the organisation, including its commitment to its stated values, ethics, and legal/regulatory compliance. This is particularly true in a complex business environment, as companies move quickly to innovate and capitalise on opportunities in new markets, leverage new technologies and data, engage with more vendors and third parties across complex supply chains.

Closely monitor the tone at the top and culture throughout the organisation with a sharp focus on behaviors (not just results) and yellow flags. Is senior management



sensitive to ongoing pressures on employees (both in the office and at home), employee health and safety, productivity, engagement and morale, and normalising work-from-home arrangements? As we have learned, leadership and communications are key, and understanding and compassion are more important than ever.

Does the company's culture make it safe for people to do the right thing? It is helpful to directors to get out in the field and meet employees to get a better feel for the culture. Help ensure that the company's regulatory compliance and monitoring programs are up to date, cover all vendors in the global supply chain, and clearly communicate the company's expectations for high ethical standards.

Focus on the effectiveness of the company's whistleblower reporting channels (including whether complaints are being submitted) and investigation processes.

Does the audit committee see all whistle-blower complaints? If not, what is the process to filter complaints that are ultimately reported to the audit committee? As a result of the radical transparency enabled by social media, the company's culture and values, commitment to integrity and legal compliance, and its brand reputation are on full display.

## 8. STAY APPRISED OF GLOBAL TAX DEVELOPMENTS, AND UNDERSTAND THAT TAX HAS BECOME AN IMPORTANT ELEMENT OF ESG

Tax has emerged as an important element of ESG, with stakeholders expecting companies to conduct their tax affairs in a sustainable manner, measured in terms of good tax governance and paying a "fair share." Many ESG stakeholders view the public disclosure of a company's approach

to tax, the amount of taxes paid, and where those taxes are paid as important elements of sustainable tax practice. We have now seen several shareholder proposals calling for companies to report on their tax practices on a country-by-country basis under the Global Reporting Initiative.

In this environment, it is important for audit committees to engage with the management in at least three areas:

- Understand the risks posed by the uncertainty and complexity of this evolving tax landscape, as it is likely to have a significant effect on the company in the coming years.
- Help articulate the company's tolerance for reputational risk associated with tax choices that are being made, and evaluate the extent to which the corporate governance framework and associated controls are in place to minimise this risk and or improve sustainability scores.
- Help determine the right approach to tax transparency, as there is no consensus as to what level of reporting constitutes "good tax transparency." Management teams will need to consider stakeholder expectations, relevant standards, regulators, and the tax transparency disclosures of their peers.

## 9. TAKE A FRESH LOOK AT THE AUDIT COMMITTEE'S COMPOSITION AND SKILL SETS

As the role and responsibilities of the audit committee continue to expand and evolve beyond its core oversight responsibility for financial reporting and control risks, the committee must continue to assess whether it has the right composition and skill sets.

In making that assessment, we recommend three areas to probe as part of the committee's annual self-evaluation:

- How many audit committee members spent their careers working on financial accounting, reporting, and control issues? Is the committee relying only on one or two members to do the "heavy lifting" in the oversight of financial reporting and controls?
- Does the audit committee include members who have the experience and skill sets necessary to oversee areas of risk (beyond the committee's core responsibility) which the audit committee has been assigned – such as cyber and data security, supply chain issues and geopolitical risk, ESG risks and disclosures, or climate?
- As the audit committee's workload expands to include oversight of disclosures for non-financial information – including climate, environmental and social issues – as well as related disclosure controls and procedures and internal controls, does the committee have the necessary financial reporting and internal control expertise to effectively carry out these responsibilities as well as its core oversight responsibilities? Does the committee need to hire experts in order to discharge its oversight duties?

With investors and regulators focusing on audit committee composition and skill sets – as well as audit committee agenda overload – this is an important issue for audit committees.

*This document has been created as part of KPMG's global Board Leadership Centre Program network. While it makes some reference to foreign regulation, it highlights the commonality of issues facing directors around the globe.*

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