KPMG

On the 2023 Audit Committee Agenda

KPMG Nigeria Board Governance Centre

January 2023

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 the convergence of economic and regulatory stressors to the tight talent market.

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

Keep an eye on macro-economic issues

We are in a challenging business environment. Rising inflation rates has become prevalent. Central banks around the world are aggressively raising rates, supply chain disruptions persist and consumer demand that was strong during the strictest of the pandemic measures may taper off. According to the latest **KPMG International CEO Outlook** most CEOs (86%) believe a recession will emerge over the next 12 months.

Geopolitical and social forces including developments in supply chain disruptions, insecurity, fuel scarcity, upcoming general elections, recent CBN's monetary policy on the introduction of new naira notes and re-introduction of the cashless policy may impact organisations.

The talent flight (Japa) is intense, and employees are demanding dramatic changes to work and the workplace.

Stakeholders - including regulators - have demands around the environment, social issues and corporate governance. Even large companies with skilled management are experiencing difficulties because the macro factors are moving so quickly against them.

Additionally, many management teams, boards and audit committees have never experienced the combination of a global recession, inflation or interest rates at these levels.

We're moving from an era of growing revenue to maintaining profitability, which means audit committees will need to look below the top line and pay more attention to gross margins, costs, and profits. Faced with so many challenges, many management teams and boards are busy putting out fires and attempting to appease every stakeholder. But they need to step back, carefully choose the most important stakeholders to satisfy and formulate a strategy to get through this period and come out of it stronger in the longer term.

As organisations prepare for a recession, it's important that audit committees move their discussions toward what they need to hear and not what management thinks they want to hear. Audit committees should be adamant that their management report anything that's a concern and ask for a 'no surprise' approach to running the business.

Some of the actions that can be undertaken include:

Watch your cash flow

The cash flow statement is the most important statement in this environment. Management and boards must closely monitor cash flow; discussions of adjusted EBITDA need to be replaced with discussions of cash management. Cash flow is the simplest model for measuring the business and an indicator of emerging problems. A company either has cash or it doesn't; it's either flowing in from somewhere or out to somewhere and can signal that an organisation's liabilities outweighs its assets.

In difficult times, it should be reviewed frequently by senior management.

How the cash flow statement is built is just as important as the cash flow itself. Audit committees must ensure management is maintaining proper governance, controls and processes around cash flow reporting; that they have thorough understanding of their cash flow forecasting models; and that their assumptions and processes are reasonable.

Understand your debt

In the face of rapidly rising lending rates and a potential economic slowdown, organisation's need to be sure they understand their debt and capital structure. Some organisations are already resetting their debt due to market conditions, and management should review their debt agreements and understand the covenants -including potential rate step-ups, reporting requirements and default triggers. Companies with sub-optimal balance sheets should prioritise exploring options to strengthen them. The audit committee should be sure that management understands the company's debt and has run reasonable scenarios around any changes.

Some questions the audit committee should be asking include

- Do we understand our cashflow forecasting tools and key operating statistics?
- Do we understand our debt structure going into a possible recession?
- Are we effectively managing our working capital and maximizing out liquidity?
- Are we proactive in engaging our CFO, lenders and other stakeholders?
- How do we manage the challenges of this environment while recognizing the opportunity to take advantage of transformation projects to grow the business?

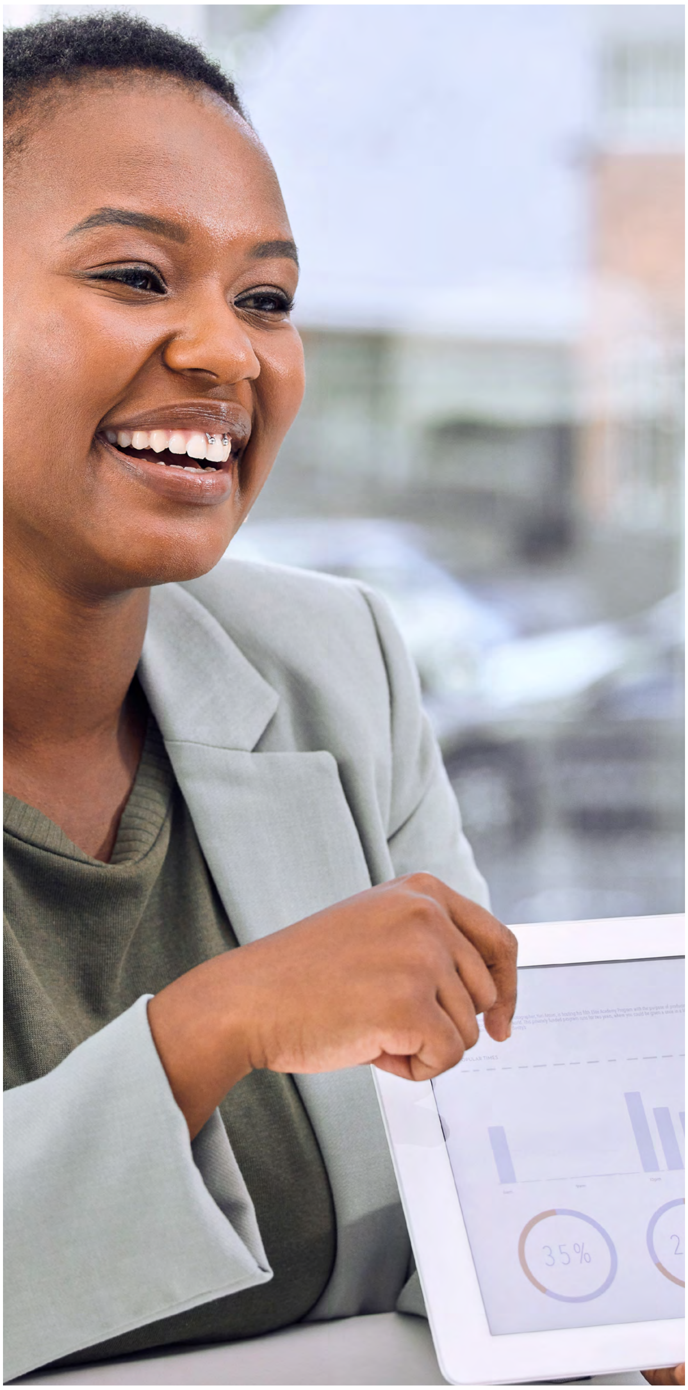
Doing nothing is not a good strategy

A recession can be a good opportunity for the board to determine a strategy for the next one to three years. For instance, if the company has, or can build, a war chest, then it may be a good time to explore acquisitions as valuations fall for potentially distressed targets. On the other hand, if they don't think the organisation can survive the recession then it might make sense to sell some or all of it.

Management should be looking for ways to take advantage of this environment, adapting to negative market forces can be a catalyst to becoming leaner. That means moving past fear of the situation and looking to build their balance sheet.

Difficult economic times can build discipline within an organisation, which can improve profitability. For instance, spending often gets questioned at every level and this can lead to transformative cost-cutting initiatives.

These can be daunting times for organisations. By paying close attention to their cash flow, understanding their debt and capital structure and working to retain the right people, companies can emerge intact, or even stronger. The audit committee can also play a key role by offering their financial expertise and ensuring that management is monitoring the right measures of business performance using sound processes and controls.



Communicate frequently

Audit committees may find it difficult to move away from process and reporting, but they should aim to be more proactive in their approach. This may mean more frequent check-in with the CFO, rather than waiting until quarterly meetings.

The audit committee should proactively ask the hard questions of management to gain insight and make the necessary oversight decisions. For instance,

- What are the key operating statistics?
- What are the key risks for the organisation?
- Have they run scenarios to help manage around these key risks?
- Are the procedures and assumptions used for the scenarios reasonable?

Proactive engagements with other stakeholders for example, financial advisors, tax advisors, etc can be valuable in helping to navigate the challenging times. Often, organisations wait too long till they have a crisis before engaging.

Review the composition of the audit committee

The role of the audit committee has expanded beyond oversight on financial reporting and audit to becoming a guiding light for the board as it navigates these challenging times. Audit committee members are typically more financially-oriented than their boardroom peers and bring insight into managing liquidity, debt structures and the capital structure.

The stakes are high. A board resolution is required to be signed if a company is going through certain formal insolvency proceedings, potentially exposing officers and directors, and their decision making during difficult times.

It is imperative that the audit committee composition is adequate and ensures that the right skills and experience is within the committee to enable them deliver effectively. The audit committee may thus want to review their own structure and their processes and procedures and ask themselves if they have the right people on the committee, whether they have the resources they need and whether the committee, as it currently stands, is set up to weather these times. They shouldn't be afraid

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 for 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? 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 supply chain disruptions, cybersecurity, inflation, interest rates, market volatility, climate change and other 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 need to develop an Audit and Assurance Policy – is empowering some audit committees to extend the independent (external) assurance they receive whether from the external auditor or other third-party assurance providers.

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 battling with so many issues, internal audit should be a valuable resource for the audit committee and a crucial voice on risk and control matters.

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, leadership, and corporate culture, climate, cybersecurity and data governance and privacy, as well as the risks associated with the company's disclosures. Disclosure controls and procedures and internal controls should be a key area of internal audit focus. Audit committee should 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 internal audit function 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 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. Key questions to be asked include:

- 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?

Clear expectations should be set to 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.

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 hybrid/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.

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.

Review your readiness for internal control over financial reporting and probe 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 introduction of a stronger framework for internal controls via the guideline on the implementation of Sections 61- 63 of the Investments and Security Act, 2007 – 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 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 or if they require more attention and 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.

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 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:

During the pandemic, many people - including senior managers - revaluated their careers, working conditions and work-life balance. Also, as a result of the talent flight (Japa) many companies have lost experienced management, and new leaders may not know the company's business well enough; they are playing catch up and may not spot or understand patterns occurring in the business. When a CFO leaves, the role of the audit committee becomes critical because they have institutional knowledge that left with the CFO. Audit committees need to ensure the organisation has an adequate incentive and retention program to keep their best people, and a succession plan in the event they leave.

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 reporting and digital transformation strategies and help ensure that finance has the leadership, talent, and bench strength to execute those strategies.

About the KPMG Board Governance Centre

The KPMG Board Governance Centre (BGC) is a dedicated forum that provides Board members with insights and resources to keep abreast of current and emerging governance issues.

The KPMG BGC offer thought leadership and timely resources including periodic seminars and round tables to host the exchange of views and support Board members (including Board sub-committee members) in clarifying and enhancing their governance practices amid rapidly evolving corporate governance landscape in Nigeria.

Learn more: ***http://bit.ly/board-governance-centre***

Contact Us

Tomi Adepoju
Partner & Head,
Board Governance Centre
E: KPMGBoardCentre@ng.kpmg.com
T: +234 1 2718950; +234 1 2718955

Contributions

Tolu Odukale
Partner & Head,
Internal Audit, Governance,
Risk & Compliance Services

Bimpe Afolabi
Partner
Internal Audit, Governance,
Risk & Compliance Services

home.kpmg/ng
home.kpmg/socialmedia