# On the 2023 audit committee agenda

## Board Leadership Centre Saudi Arabia

The business and risk environment has changed dramatically over the few years, emerging from two years of pandemic-driven challenges, greater global geopolitical instability, surging inflation, and the prospect of a global recession now added to the mix of macroeconomic risks. Amid this growing external instability, Saudi Arabia's domestic economy showed resilience, with high international oil prices supporting an economic recovery across both the oil and non-oil sectors. 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. We continue to see how important trust and transparency are. The audit committee's oversight role has never been more important or more challenging.

In this volatile and opaque operating environment, demands by regulators, investors, and other stakeholders for more action and greater disclosure and transparency with the increased awareness 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 eight issues to keep in mind as audit committees consider and carry out their 2023 agendas:

### 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 abovementioned geopolitical and economic environment – 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 the following.

### Making tough calls: Forecasting and disclosures

The uncertainties, coupled with the extensive use of forward-looking information, estimates and judgements in preparing financial statements and related disclosures about matters that directly or indirectly impact the company's business would continue to be a top area of focus. Matters requiring the audit committee's attention might include:

- Preparation of forward-looking cash-flow estimates; impairment of non-financial assets, including goodwill and other intangible assets.
- Accounting for financial assets (fair value).
- The use of going concern assumption - 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.
- Disclosures regarding the impact, if any arising from the Russia-Ukraine war and sanctions, supply chain disruptions, heightened cybersecurity risk, inflation, interest rates, market volatility, and the risk of a global recession.

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

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 the occurrence of such instances, the continued focus on action plans, individuals responsible to fix the gaps and target dates would continue to be an agenda discussion in the audit committee meetings. We suggest the audit committee should consider:

- 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 walk the talk?

## Clarify the role of the audit committee in overseeing the company's ESG risks

Intensifying demands in relation to ESG disclosures should be prompting boards to reassess their oversight structure relating to ESG risks and disclosures. We expect that soon investors, regulators, ESG rating firms, and other stakeholders seek ESG information that is decision-useful, accurate, and comparable. These expectations have heightened concerns about the audit committee experience, bandwidth and overload. Accordingly, it would become very important to clarify the role and responsibilities of the audit committee in this respect.

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.

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.

We are of the view that globally 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.

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 Board of Directors 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).

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

## Maintain a sharp focus on leadership and talent in the finance organization

Finance organizations 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 financial and non-financial 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 that the audit committees should consider:

- What is the general level of talent in the finance function and does the established process factor-in investment requirements as a result of continuous financial reporting and compliance mandate?
- Does the finance function have the leadership, talent, skill sets, and other resources necessary to address financial and non-financial (for example: climate, other ESG, IKTVA) or other 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?
- Is finance attracting, developing, and retaining the talent and skills necessary to match its evolving needs?

- Has adequate budget been allocated towards costs involved in respect of continuous professional development of the finance function?

We are of the view that the strong analytics and strategic capabilities in the finance function combined with traditional financial reporting, accounting, and auditing skills must change to address the challenges in respect of completeness and accuracy of financial and non-financial information. It is essential that the audit committee devote adequate time to understand finance's digital transformation and ESG reporting strategies and help ensure that finance has the leadership, talent, and bench strength to execute those strategies.

## 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. Accordingly, the audit committee should always take the lead in helping to ensure audit quality.

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? Ask regarding the firm's internal quality control system, consider the results of recent regulatory inspections and internal inspections and efforts to address deficiencies.
- Is the auditor planning to deploy appropriate technologies such as smart analytics and artificial intelligence in response to various financial system / processes including database employed by the company? Discuss insights gained into areas of heightened risk and control weaknesses.
- What is the planned nature of consultation, if any, that would be held with other accountants or auditors?
- What additional audit procedures have been planned by the auditor to assess the reasonableness of estimates and judgements used by the management, particularly with respect to forward looking information?
- 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 and how it would impact the audit strategy?
- What is the nature of relationship between the auditor, management and internal audit function?
- 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 organization.

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.

It is important to be cognizant 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. Lastly, consider the changes in the regulations relating to the rotation of auditors and its impact on the existing auditors.

## 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 as described above – 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 risk, but on critical operational and technology risks and related controls, as well as 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.

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. To help ensure that internal audit is focused on these key risks and related controls, we suggest that the audit committees should consider:

- With the tight labor market and the ongoing war for talent, consider if the internal audit haw the necessary resources and skill sets? Recognize that internal audit is not immune to these talent pressures.
- What's changed in the operating environment?
- What are the risks posed by the company's digital transformation and by the company's extended organization – 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?
- Is the coverage of internal audit adequate including periodicity, geography, locations, sites, and business units?

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.

### 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 organization, 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 capitalize on opportunities in new markets, leverage new technologies and data, engage with more vendors and third parties across complex supply chains. We suggest that the audit committees should consider:

- Closely monitor the tone at the top and culture throughout the organization 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?
- Does the company's culture make it safe for people to do the right thing? Help ensure that the company's regulatory compliance and monitoring programs are up to date, cover all vendors in the 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

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."

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 minimize 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.

### 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.

# Contact us

## KPMG Board Leadership Centre

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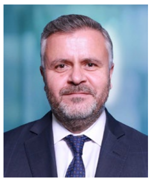

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