EVOLVING RISK IN THE FINANCIAL PANORAMA : ROLE OF AUDITORS

Debashis Ghosh, FCA

Changing Face of Risk

" WELL, I *TOLD* YOU NOT TO OPEN THAT ATTACHMENT! "

"You can go home now. The virus was in the diagnostic computer."

Technological driven risk resulting from adverse outcomes of AI remains a fairly dominant global risk.

Major Risk Themes for 2024

- **Economic concerns zoom to top risk position in near term.** Economic conditions, particularly inflationary pressures, replaced the ability to attract, develop and retain top talent.

- Many technology related challenges include escalated **cyber security risks**, continued **data privacy concerns** linked to increased third party reliance.

- **Disruptive innovations and the inability to utilize rigorous data analytics** are creating significant hurdles for organization's long term competitive positioning.

- Continued advances in **generative AI** & other technologies are driving a wave of disruption that will impact business models, sweep away obsolete strategies and alter customer experiences.

- **Supply chain disruption** can have widespread impact on any organization's sustainability and may hit bottom line severally.

- **Regulatory changes and scrutiny** are heightened for the near term to future. Potential expansion in rules and regulatory oversight is creating increased concerns not only for 2024, but also for future years.

Climate Change

Climate change impact

- Climate change has implications for operational decision making, financial reporting, auditing and investment analysis, which are all interlinked.

- The responsibilities of management and auditors concerning climate change include analyzing environmental programs, conducting issue audits, and ensuring compliance with regulations.

- Investors can expect most auditors to consider the potential impact of climate risk, to some extent at least, as part of their planning and risk assessment procedures.

- It's important to remember the primary purpose of financial statements is to set out the financial performance of a company over a specific past period and its financial position as of a particular past date.

- It is all the more challenging when as a society our knowledge about climate change is constantly evolving and auditors can't possibly anticipate the multitude of effects it may have on businesses. Nonetheless, the audit profession can work hard to stay abreast of this complex area so that shareholders can rely on and trust our audit opinions.

Artificial Intelligence risk

AI generated risk impact

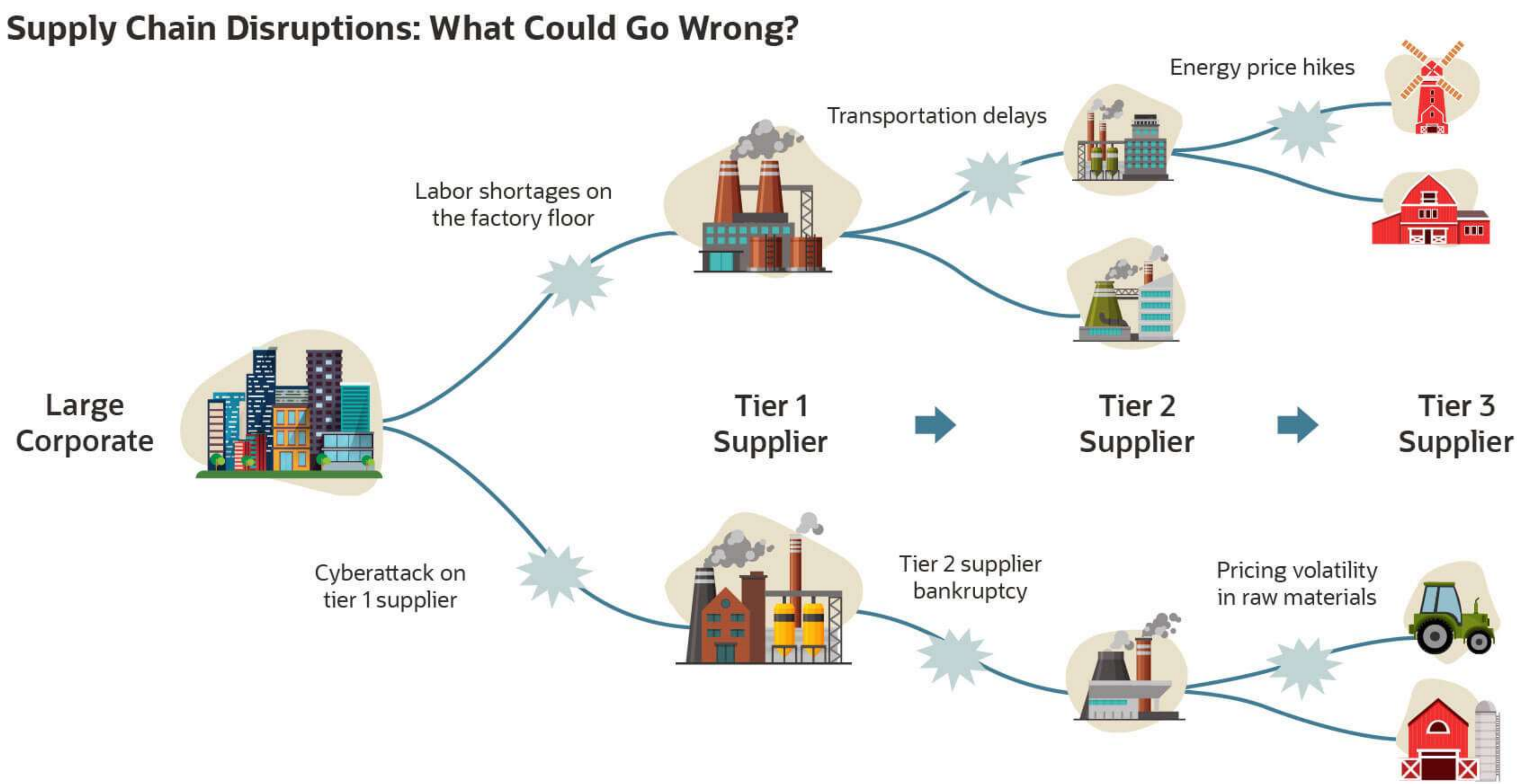
- ChatGPT and other globally recognized tools like Bard, Bing Chat, Claude, Perplexity, and others, regularly experience " Hallucinations". In simple terms, this is when the language tool dispenses content that is not rooted in factual evidence, but rather, conjecture. It often boils down to the specific tool simply satisfying the user's prompt or request as closely and as quickly as possible, completely ignoring context and factual accuracy.
- However, an underlying problem persists. The constant use of AI-generated text, which is only going to grow in the coming months and years, runs the risk of the potential spread of misinformation, disinformation, and fake news.

- Misinformed AI content can have long-term **Cyber security Risk** too, especially if AI tools aggregate and distribute data without any filters for its sensitivity.

- While AI promises numerous benefits, the absence of proper safeguards, unsupervised AI-powered applications and tools and dispensed misinformed discourse could do more harm than good, which is why business leaders must take affirmative preventative action before it spirals out of control.

Supply chain risk

Supply chain



Supply chain impact

- Fundamental changes in consumer behavior, markets, and supply chains are knocking companies off balance. The sheer scale and speed of change requires rapid responses.

- Companies need to accelerate value chain transformation. And they need strong data and analytics capabilities. Such capabilities are key to understanding complexity, anticipating potential disruption, and quickly developing a response.

- Businesses need to create value chains with long term resilience . This requires holistic approaches to managing the supply chain. Companies must build in sufficient flexibility to protect against future disruptions. And they need a responsive and resilient risk management operations capability.

- The effects of a supply chain disruption can be immediate and widespread, with each action traveling down the line. In the end, smarter business practices can help alleviate these occurrences, and lead to a stronger system.

Productivity risk

Stagflation

- In 2024, persistent inflation and dampening demand could trigger the stagflation trap. It is important to watch the central banks' balancing act between tightening monetary policy to keep inflation at bay, while avoiding a permanent depression of global demand and investment growth.
- This maybe very tricky, especially if the supply side causes of inflation persist i.e., Supply chain disruptions, demographic challenges, impact of the war in Ukraine on critical commodities.
- As such, business leaders may face **2** types of profit margin erosion:
  - High **input and operational costs such as energy, raw material, and labour.** Companies with sophisticated supply chains might have to spend more on beefing up inventory just to avoid supply shortages and maintain a certain level of output.
  - **Weakening demand** will vary between markets and sectors depending on a) intensity of economic shock on customer confidence, b) essential nature of a particular industry, c) effectiveness of fiscal policy intervention and d) government's ability to boost public expenditure.

ESG risk

ESG impact

- The global instability being experienced is likely to lead to continued crisis, requiring high level and sophisticated corporate responses. A coherent and comprehensive ESG strategy will be the key, even as the future of ESG standards and reporting suffer from growing global fragmentation.

- As ESG standards mature, there maybe more uncomfortable conversations about regional and cultural expectations for each ESG category.

- For global companies, however, navigating this field will require careful and conscious trade offs. The nuances of this outlook, make it even more necessary that functions like **corporate affairs, risk management and sustainability teams** be included in high level business decisions.

ESG compliance

- Agile governance is key to addressing risk which are not easily quantifiable, increasingly non-linear and with wide-ranging first and second order business impact.
- **ESG landscape:** Identify ESG trends and drivers that could impact business, and how businesses compares with direct peers and best in class ESG companies.
- **ESG maturity and ambition assessment:** Benchmark ESG maturity against industry frameworks and good market practice.
- **Materiality Assessments:** Identify ESG risks and opportunities that are material to the business.
- **Develop ESG strategy and strategic options:** Focus on long-term value and competitive advantage, outlining strategic options and platforms that could enable access to key opportunities and prioritize and mitigate risks.
- **Circular economy practices:** Evaluate circular economy targets and ambitions against operating models and performance metrics. Eliminate waste and reduce costs throughout the product life-cycle and across the entire supply chain function.
- **Compelling ESG story communication:** Manage stakeholders' expectations and enhance brand perception amongst customers, employees, lenders and shareholders.

Key Risk Issues Analyzed

Macro-Economic Risk Issues

- Increases in **Labour Cost –** may affect opportunity to meet profitability targets
- Volatility in **Global Financial Markets** and currency exchange rates
- Changes in Global Markets and **Trade Policies-** escalating tariffs, cross- border restrictions, targeted embargoes, shifts to multilateralism and emergence of regional trading alliances
- Access to **Capital and Liquidity**
- Economic conditions including **Inflationary pressures**
- Adoption of **Digital Technologies** requiring new skills in short supply
- **Geopolitical shifts**, regional conflicts and instability in governmental regimes or expansion of global terrorism
- Impact of **social issues** and ability to attract and retain talent and compete

Strategic Risk Issues

- Rapid speed of **disruptive innovations** enabled by new and emerging technologies like AI, faster data transmission, quantum computing, blockchain, digital currencies and the metaverse (virtual world with 3D images)
- **Social media developments** and platform technology innovations
- Heightened **regulatory changes** and scrutiny
- Growing focus on **climate change** and other sustainable policies, regulations and expanding disclosure requirements as well as expectations of key stakeholders
- Ease of entrance of **new competitors**
- Limited opportunities for **organic growth**
- Sustaining customer **loyalty and retention**

Operational Risk Issues

- Challenges in **sustaining culture** due to changes in the overall cross border work environment
- Uncertainty surrounding core **supply chain eco-system** – viability of key suppliers, scarcity of supplies.
- **Third-party risks-** reliance on outsourcing and strategic sourcing arrangements, ecosystem partners, IT vendor contracts may prevent the organization from meeting its targets and impact brand image and reputation
- Ability to attract, **develop and retain top talent,** manage shifts in labour expectations and address succession challenges
- **Cyber Threats** such as ransomware and other attacks that have the potential to significantly disrupt core operations
- Enhanced exposure to **fraud** in the industry
- Ensuring **data privacy** and compliance with growing identity protection expectations
- Existing operations and legacy **IT infrastructure** unable to meet performance expectations

Risk Mitigation Measures

Source and Retain Talent

- There are several steps that firms can take to mitigate the **risk of disruption, minimize reputational risk, and retain talent**:
- First, firms should ensure that employees and company assets will be secure in the event of instability.
- In wage negotiations, **equity and transparency** are more important than ever. Given the growing set of social expectations that consumers place on executives, management should communicate thoughtfully, openly, and proactively with staff to avert reputational consequences. This is especially true for global brands and multinationals, which may have to navigate different wage-setting conditions across countries.
- When budget constraints are binding, **flexibility and responsiveness may go a long way toward retaining talent.** If firms cannot fully satisfy workers' wage demands, offering other benefits, such as more flexible working times or additional leave, can communicate commitment to staff. Building company culture and providing more intensive feedback and training particularly for early-career employees and new-joiners can also help to improve cohesion.

Strategy to Unlock Value amidst High Inflation and Rising Capital Costs

- **Current market conditions, technological disruption and geopolitically driven economic headwinds** not only make executing deals and value creation more important but also more complex than ever before.

- Against this backdrop, dealmakers should proactively **design new investment strategies** to focus on value creation and productivity to secure sustainable long-term returns. This could include investing in **new verticals** to address market change or other geopolitical trends, such as **semiconductors, drones, education technology, cyber security, in-home care, medical devices, domestic tourism, green technologies, radiology, and hybrid work-related businesses**, to name a few.

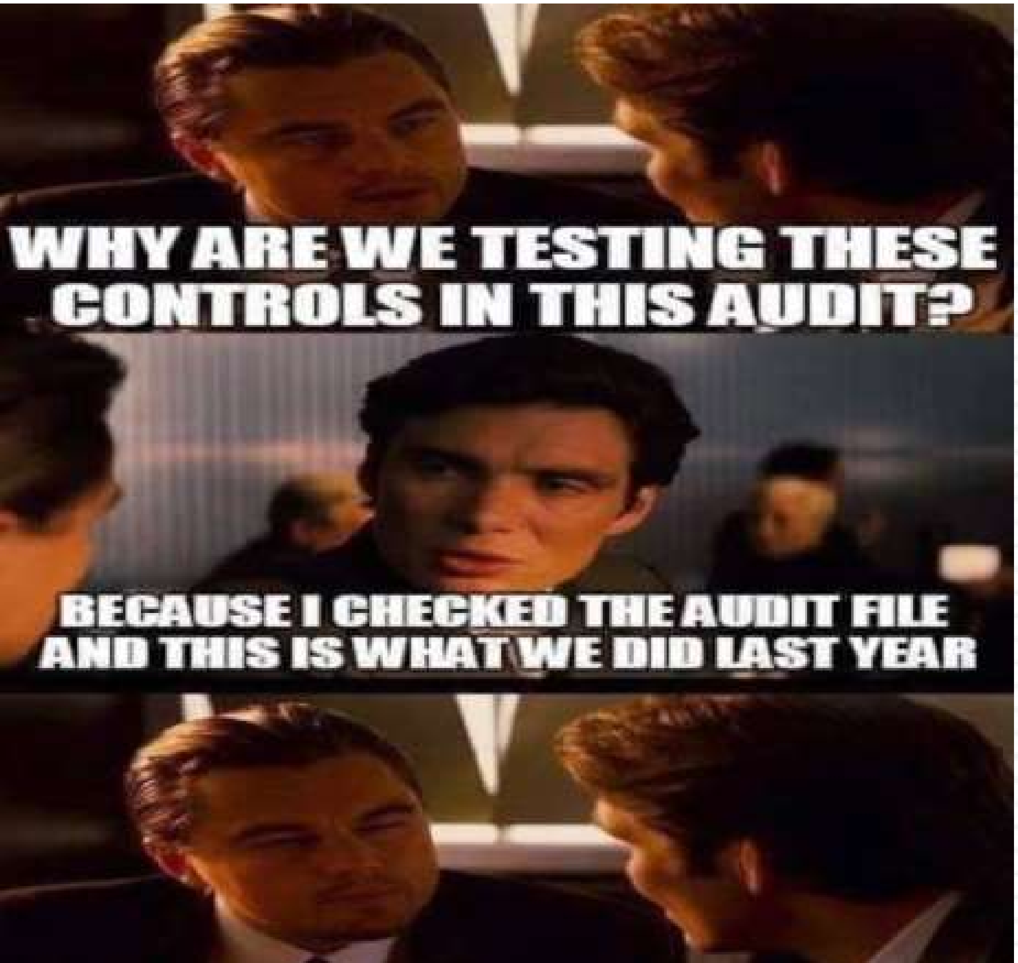
- With a broader range of opportunities but also risks at stake, new imperatives to grow and a competitive deal environment, it is important for both sides of every transaction to leverage **big data** and **advanced analytics**. This helps reduce risk, empowers teams to develop more informed strategies and builds competitive advantage.

Strategy to Unlock Value amidst High Inflation and Rising Capital Costs(contd.)

- When contextualized by the right sector, market and geographical insight, **advanced analytics** may also provide deal practitioners with the **right intelligence** at the **right time** despite limited information from sellers or bidders. Early in the deal process, the right data and analytics tools can help with the workflow and analysis, which includes framing ideas, investment hypotheses and anticipating likely bidders' thinking.

- A **political risk due diligence** exercise could also complement traditional commercial due diligence efforts.
- Business should be able to answer three questions:
  - How will political uncertainty impact core financial assumptions ?
  - What political risks might jeopardize ability to realize future revenue and income ?
  - What underlying political assumptions are necessary for a business plan's success ?

Role of Audit Going Ahead



"I don't want to change. I want all of you to change!"

Strategic Role of Auditor

A modern audit should understand organization's key risks, proactively identify emerging risks to add value to the organization thereby assisting in efficient and effective allocation of resources and further develop its strategic role.

- Understand Key Business Matters
- Leveraging Technology
- Ensure that Auditing Create Business Value
- Consider Who is Seeking Assurance

Biggest Challenge for Auditors

Disruptive forces for change will always bring challenges but, in order to fulfil its vital role in society, auditors and the wider finance profession will need to continue to adapt and evolve

Technological Revolution

- Massive shifts in technology like Data Automation, Blockchain and AI are ushering in what some are calling the 'Fourth Industrial Revolution' or perhaps more accurately) 'the Transformation Economy'.

Trust in Business

- With all this disruption, there is a second growing challenge for this profession - how we stay relevant and trusted to the people who rely on what we do.

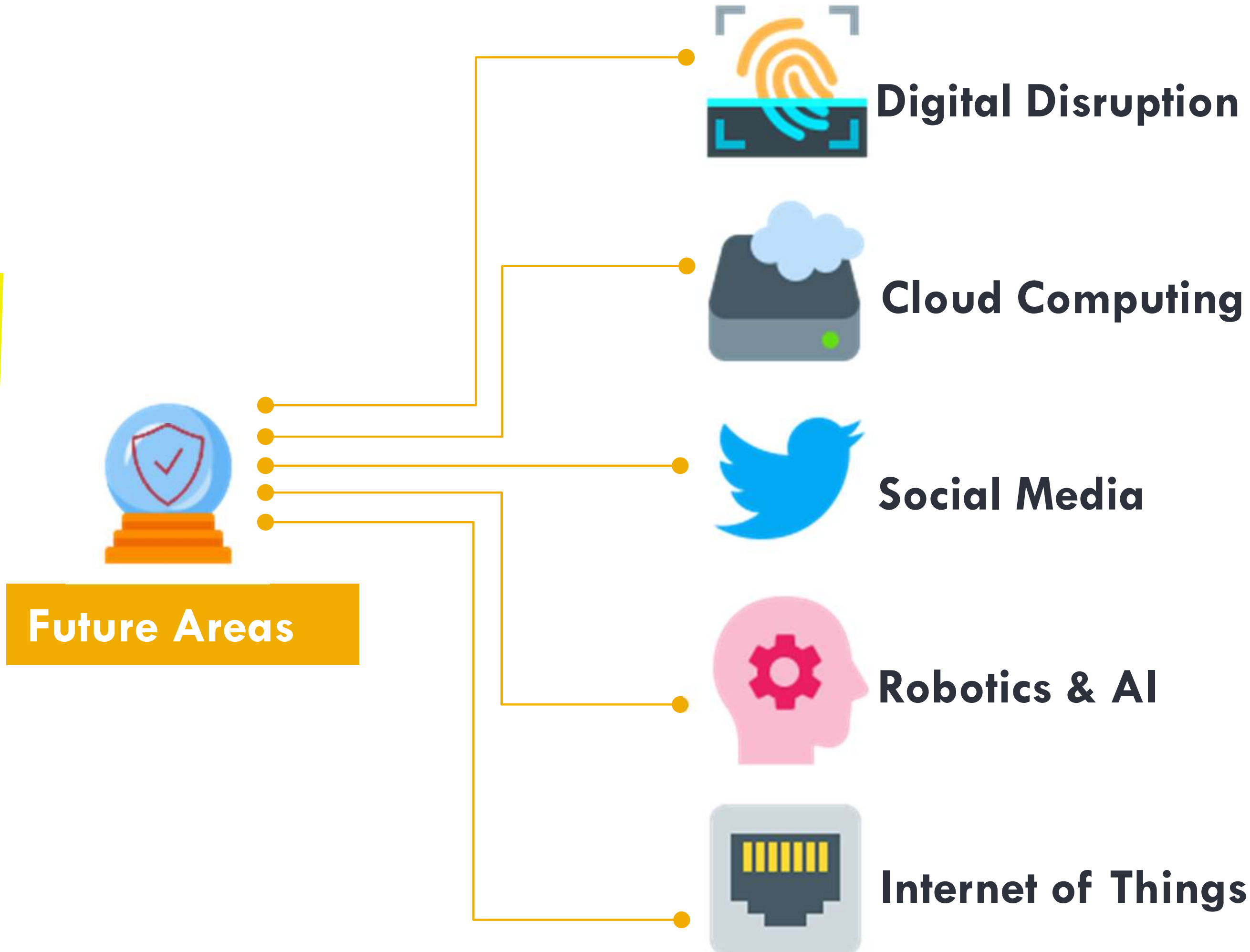
Shifting Geopolitical Landscape

- With the shifting geopolitical changes such as UK's relationship with Europe, Ukraine war with Russia, India 's relationship with US, Europe and Russia, Elections outcome in India and sub continent , volatile relationships in few neighbors, there will definitely be a period of change and uncertainty. However, the implications remain unclear.

Audit: Changing Focus

Current Focus

- Data Privacy
- Privileged User Access
- Change Management
- Cybersecurity
- Data Management
- IT Governance
- Regulatory Compliance
- Third Parties / Vendors
- Fraud
- Records Retention



Enablers

- Audit Data Analytics
- Big Data
- Conti-nuous Auditing

An eye on the future

Risk Management in 2025

- By 2025, risk functions will likely need to be fundamentally different than they are today
- Next ten years in risk management may be subject to more transformation than the last decade
- Regulation will continue to broaden
- Customers' expectations will rise and change as technology and new business models emerge and evolve

Role of Risk Management Going Ahead

- Broader responsibilities, to be very engaged at a strategic level, and to have much stronger, collaborative relationships
- Talent pool expertise toward better analytics and greater collaboration, and away from operating processes
- IT and data will be more sophisticated, often employing big data and complex algorithms
- Shift in the organizational risk culture - the adoption of an approach that embeds shared and communicated values and principles throughout the organization.

Vision of Risk Function in 2025

Minimizing manual interventions while making modelling, simplification, standardization, and automation

Much more rule based framework when dealing with regulations, delivering superior customer experiences, capturing the benefits of big data, and de-biasing decisions

Collaborating more closely with Business – joint reduction of operational risk, strategic planners on balance-sheet optimization, etc.

Becoming a strong advocate of corporate values and principles through a more robust risk culture that is defined, communicated and reinforced throughout the organization

Developing and hiring people with different skills who can build and manage new models and data sets, and collaborate with the businesses and other functions

Initiatives to help Risk Management for Future

- Digitization of core processes
- Experiment with advanced analytics and machine learning
- Enhanced risk reporting
- Balance-sheet optimization
- Putting the enablers in place

Conclusion

- Risk management in 2025 will become a core part of strategic planning, a close collaborator with business, and a centre of excellence in analytics and de-biased decision making

- Deploying Comprehensive Risk management programs will become Key enablers for improving organization brand value and key contributor in enhancing bottom line

Ca.dghosh@gmail.com
 # 98300-87004