Directors Quarterly

Insights from the Board Leadership Center

January 2023

Forging ahead

The practical mindset of "leaning into the humility of a forecast, while embracing the strength of scenarios"—which KPMG Chief Economist Diane Swonk discusses in our Q&A this quarter—not only applies to the economy; it should also strike a chord for boards as they help their companies navigate the risks and opportunities in the year ahead. A far less predictable business and risk environment—being shaped by ongoing economic uncertainty, lingering inflation concerns, geopolitical volatility, continuing supply chain issues, and a shifting regulatory landscape—also calls for a balance of humility and agility in the business and the boardroom.

As directors tackle a lengthy and expanding list of must-dos and focus on helping their companies prepare for the unexpected, we highlight some of the pressing issues that should be high on 2023 board and committee agendas. Meanwhile, our financial reporting and auditing update includes highlights from the 2022 AICPA & CIMA Conference on Current SEC and PCAOB Developments, the potential impacts of economic uncertainty on accounting and financial reporting, and the latest on ESG and crypto assets.

We hope you find this edition of *Directors Quarterly* helpful as you refine your board and committee agendas.

John H. Rodi
Leader
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On the 2023 board agenda

Boards can expect their oversight and corporate governance processes to be tested by an array of challenges in the year ahead—including global economic volatility, the war in Ukraine, supply chain disruptions, cybersecurity risks, regulatory and enforcement risks, and social risks, such as pay equity and the tight talent market.

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 added to the mix of macroeconomic risks companies face in 2023. The increasing complexity and fusion of risks unfolding simultaneously, and the increased interconnectedness of these risks up the ante for boards to have holistic risk management and oversight processes.

In this volatile operating environment, demands from employees, regulators, investors, and other stakeholders for greater transparency and disclosure—particularly around cybersecurity, climate, and other environmental, social, and governance (ESG) risks—will continue to intensify.

Drawing on insights from our latest surveys and interactions with directors and business leaders, we highlight nine issues to keep in mind as boards consider and carry out their 2023 agendas:

- **Maintain focus on how management is addressing geopolitical and economic risks and uncertainty.**
- **Monitor management's projects to build and maintain supply chain resilience.**
- **Reassess the board's committee structure and risk oversight responsibilities.**
- **Keep ESG, including climate risk and DEI, embedded in risk and strategy discussions and monitor U.S. and global regulatory developments.**
- **Clarify when the CEO should speak out on social issues.**
- **Approach cybersecurity, data privacy, and artificial intelligence (AI) holistically as data governance.**
- **Make talent, human capital management (HCM), and CEO succession a priority.**
- **Engage proactively with shareholders, activists, and other stakeholders.**
- **Think strategically about talent, expertise, and diversity in the boardroom.**

Maintain focus on how management is addressing geopolitical and economic risks and uncertainty.

Heading into 2023, developments in the war in Ukraine, tensions with China, supply chain disruptions, energy shortages in Europe, cybersecurity, inflation, rising interest rates, market volatility, trade tensions, and the risk of a global recession will continue to drive global volatility and uncertainty.

This environment will call for continual updating of the company's risk profile and more scenario planning, stress-testing strategic assumptions, and analyzing downside scenarios. Leaders will need to assess the speed at which risks are evolving, their interconnectedness, the potential for multiple crises at the same time, and whether there is flexibility in the company's strategy to pivot.

Oversee management's reassessment of the company's processes for identifying and managing these risks and their impact on the company's strategy and operations.

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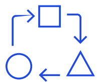
- Is there an effective process to monitor changes in the external environment and provide early warning that adjustments to strategy might be necessary?
- Is the company prepared to weather an economic downturn?

Help management keep sight of how the big picture is changing—connecting dots, thinking differently, and staying agile and alert to what's happening in the world. Disruption, strategy, and risk should be hardwired together in boardroom discussions.

Challenge and question management's crisis response plans.

- Are they robust, actively tested or war-gamed, and updated as needed?
- Do they include communications protocols to keep the board apprised of events and the company's response as well as to determine when/if to disclose matters internally and/or externally?

Make business continuity and resilience part of the discussion. *Resilience* is the ability to bounce back when something goes wrong *and* the ability to stand back up with viable strategic options for staying competitive and on the offense in the event of a crisis, such as ransomware, a cyberattack, or a pandemic.



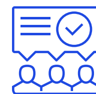
Monitor management's projects to build and maintain supply chain resilience.

Companies continue to navigate unprecedented supply chain stresses and strains with the ultimate goal of assuring supply—and survival. Amid ongoing supply chain turmoil, many companies are implementing efforts to address vulnerabilities and improve resilience and sustainability. Boards should help ensure that management's projects to rethink, rework, or restore critical supply chains are carried out effectively, such as:

- Updating supply chain risk and vulnerability assessments
- Diversifying the supplier base
- Reexamining supply chain structure and footprint
- Developing more local and regional supply chains
- Deploying technology to improve supply chain visibility and risk management
- Improving supply chain cybersecurity to enhance resilience from disruption and reduce the risk of data breaches, such as SolarWinds and Kaseya
- Developing plans to address future supply chain disruptions.

Importantly, are supply chain projects being driven by an overarching vision and strategy? Who is leading the effort, connecting critical dots, and providing accountability?

At the same time, boards need to sharpen their focus on the company's efforts to manage a broad range of ESG risks in its supply chain. Such risks—particularly climate change and other environmental risks as well as important "S" risks such as human rights; forced labor; child labor; worker health and safety; and diversity, equity, and inclusion (DEI) in the supply chain—pose significant regulatory and compliance risks as well as critical reputation risks for the company.



Reassess the board's committee structure and risk oversight responsibilities.

The increasing complexity and fusion of risks unfolding simultaneously requires a more holistic approach to risk management and oversight. At the same time, investors, regulators, ESG rating firms, and other stakeholders are demanding higher-quality disclosures—particularly on climate, cybersecurity, and other ESG risks—and about how boards and their committees oversee the management of these risks.

Given this challenging risk environment, many boards are reassessing the risks assigned to each standing committee. In the process, they are considering whether to reduce the major risk categories assigned to the audit committee beyond its core oversight responsibilities (financial reporting and related internal controls and oversight of internal and external auditors)—by transferring certain risks to other committees or potentially creating a new committee.

The challenge for boards is to clearly define the risk oversight responsibilities of each standing committee, identify any overlap, and implement a committee structure and governance processes that facilitates information sharing and coordination among committees. While board committee structure and oversight responsibilities will vary by company and industry, we recommend four areas of focus:

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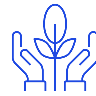
- Does the audit committee have the time and members with the experience and skill sets necessary to oversee areas of risk (beyond the committee's core responsibility) that the audit committee has been assigned—such as cybersecurity, data privacy, supply chain, geopolitical, climate, and other ESG-related risks—as well as the adequacy of management's overall ERM system and processes?
- Does another board committee(s) have the time, composition, and skill set to oversee a particular category of risk? Is there a need for an additional committee, such as a technology, sustainability, or risk committee? Is there a need for new directors with skill sets or experience to help the board oversee specific risks?
- Recognize that rarely does a risk fit neatly in a single, siloed risk category. While many companies historically managed risk in siloes, that approach is no longer viable and poses its own risks.
- Identify risks for which multiple committees have oversight responsibilities, and clearly delineate the responsibilities of each committee. For example, in the oversight of climate and other ESG risks, the nom/gov (or sustainability committee), compensation, and audit committees likely each have some oversight responsibilities. And where cybersecurity oversight resides in a technology committee (or other committee), the audit committee may also have certain responsibilities. To oversee risk effectively when two or three committees are involved, boards need to think differently about how to coordinate committee activities. For example, some boards have established a board-level ESG committee, composed of members of the board's existing standing committees, focused on ESG disclosures and issues. Also see *On the 2023 audit committee agenda*.

Essential to effectively managing a company's risks is maintaining critical alignments—of strategy, goals, risks, internal controls, incentives, and performance metrics. Today's business environment makes the maintenance of these critical alignments particularly challenging. The full board and each standing committee should play a key role in helping to ensure that—from top to bottom—management's strategy, goals, objectives, and incentives are properly aligned, performance is rigorously monitored, and that the culture the company has is the one it desires.



Keep ESG, including climate risk and DEI, embedded in risk and strategy discussions and monitor U.S. and global regulatory developments.

How companies address climate change, DEI, and other ESG issues is viewed by investors, research and ratings firms, activists, employees, customers, and regulators as fundamental to the business and critical to long-term value creation. At a time of low trust in government and institutions, corporations are being asked to do more to solve societal problems—or run the risk of losing the social license to operate.

While there are trillions of dollars in investments in various types of ESG funds, there is also pushback against ESG, as some states and public officials are stepping up efforts to prevent investors—particularly state pension funds—from considering ESG issues in their investment decisions.

Forbes noted that this pushback may, in fact, be good for ESG: "Recent pushback on ESG is a sign that it is evolving, with stakeholders taking steps to make ESG efforts more consistently tangible, meaningful, and measurable. Calling out misinformed approaches helps make the case for proper design and action. Many business leaders are using the critique of ESG programs to analyze their current approach and rethink their strategies to create more value and impact."[1]

The ESG issues of importance will vary by company and industry. For some, it skews toward environmental, climate change, and emission of greenhouse gases. For others, it skews toward DEI and social issues.

- How is the board helping to ensure that these issues are priorities for the company and that the company is following through on its commitments?
- How is the company embedding these issues into core business activities (strategy, operations, risk management, incentives, and corporate culture) to drive long-term performance?
- Is there a clear commitment and strong leadership from the top and enterprise-wide buy-in? Are there clear goals and metrics?
- Is management sensitive to the risks posed by greenwashing?

Demands for higher-quality climate and other ESG disclosures should be prompting boards and

[1] John M. Bremen, "Why the Pushback On ESG Is Good for ESG," June 16, 2022.

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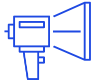
management teams to reassess and adjust their governance and oversight structure relating to climate and other ESG risks—and to monitor SEC and global regulatory developments in these areas. Indeed, the spotlight has intensified with the SEC's rulemaking proposals for climate and cybersecurity disclosures, anticipated SEC rulemaking on HCM disclosures, recent ESG-related SEC enforcement actions, shareholder proposals on ESG issues, and other global ESG and sustainability proposals (EU, UK, etc.).



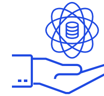
Clarify when the CEO should speak out on social issues.

From *Roe v. Wade* and voting rights to climate change and equity and inclusion, polarizing social and political issues are moving front and center in the boardroom as employees, customers, investors, and stakeholders sharpen their scrutiny of a company's public positions—or silence. When should a CEO speak out on controversial issues, if at all, and what are the potential consequences?

Consider what role the board should play in establishing parameters for the CEO as the voice of the company. Some boards have written policies; others have an informal understanding that the CEO will confer with board leadership before speaking on a controversial issue. Some companies have cross-functional management committees to vet issues on a case-by-case basis to determine when speech is appropriate.

Directors and business leaders we spoke with identified a number of criteria or considerations for determining whether or not the CEO should speak out on highly charged social and political issues:

- Is the issue relevant to the company and its strategy? Is it in alignment with the company's culture, values, and purpose?
- How will speaking out resonate with the company's employees, investors, customers, and other stakeholders? In a tight labor market, employees often choose where to work based on company values, including its willingness to speak out on certain issues, such as DEI.
- *Not* speaking out can be as powerful as speaking out on certain issues. How do the CEO and the board come to terms with that ambiguity and risk and weigh the consequences of speaking out or not?
- As the views of stakeholders are not uniform, how should CEOs and companies manage the inevitable criticism of their choice to speak or not speak? Having felt the backlash of speaking out on social/political issues, some companies have adjusted their approach to take action without trumpeting what they're doing.
- Make sure that the company's lobbying and political contributions are aligned with its speech.



Approach cybersecurity, data privacy, and AI holistically as data governance.

Cybersecurity threats are dynamic and related impacts continue to intensify. The acceleration of AI and digital strategies, the increasing sophistication of hacking and ransomware attacks, and the lack of definition for lines of responsibility—among users, companies, vendors, and government agencies—have elevated cybersecurity risk and its place on board and committee agendas.

Boards have made strides in monitoring management's cybersecurity effectiveness. For example, some have greater cybersecurity expertise on the board and relevant committees (although that expertise is in short supply). Other efforts include company and business-line-specific dashboard reporting to highlight and prioritize critical risks, vulnerabilities, and threats; war-gaming breach and response scenarios; and discussions with management on the findings of ongoing third-party risk assessments of the company's cybersecurity program. Despite these efforts, the growing sophistication of cyberattacks and the complexity of cyber risk management point to the continued challenges ahead.

These issues, and frequent failures to address concerns, have pushed regulatory bodies into action. Boards should monitor developments in the SEC's proposal on Cybersecurity Risk Management, Strategy, Governance, and Incident Disclosure as well as management's preparations to comply. The SEC rule proposal would, among other things, establish a four-business-day deadline for reporting a material cyber breach (before relevant information may be available), would *not* allow for delayed reporting for incidents subject to law enforcement or national security investigations, and would require disclosure of any cybersecurity expertise on the board. Final SEC action on the proposed rule is expected in the spring of 2023.

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While data governance overlaps with cybersecurity, it's broader and includes compliance with industry-specific privacy laws and regulations as well as privacy laws and regulations that govern how personal data—from customers, employees, or vendors—is processed, stored, collected, used, shared, and disposed. Data governance also includes policies and protocols regarding data ethics—in particular, managing the tension between how the company may use customer data in a legally permissible way and customer expectations as to how their data will be used. Managing this tension poses significant reputation and trust risks for companies and represents a critical challenge for leadership.

To oversee cybersecurity and data governance more holistically:

- Insist on a robust data governance framework that makes clear what data is being collected, how it is stored, managed, and used, and who and how decisions are made regarding these issues.
- Clarify which business leaders are responsible for data governance across the enterprise—including the roles of the chief product officer, chief information officer, chief information security officer, chief data officer, and chief compliance officer.
- Reassess how the board—through its committee structure—assigns and coordinates oversight responsibility for the company's cybersecurity and data governance frameworks, including privacy, ethics, and hygiene.

An increasingly critical area of data governance is the company's use of AI to analyze data as part of the company's decision-making process. Boards should understand the process for how AI is developed and deployed. What are the most critical AI systems and processes the company has deployed? To what extent is bias—conscious or unconscious—built into the strategy, development, algorithms, deployment, and outcomes of AI-enabled processes? What regulatory compliance and reputational risks are posed by the company's use of AI, particularly given the global regulatory focus on the need for corporate governance processes to address AI-related risks, such as bias and privacy? How is management mitigating these risks?

Many directors may be uncomfortable with responsibility for overseeing AI risk because of a lack of expertise. But, as observed by Debevoise & Plimpton: "As the SEC has made clear with respect to cybersecurity, boards need to find a way to exercise their supervision obligations, even in areas that are technical, if those areas present enterprise risk, which is already true for AI at some companies. That does not mean that directors must become AI experts or that they should be involved in day-to-day AI operations or risk management. But directors at companies with significant AI programs should consider how they will ensure effective board-level oversight with respect to the growing opportunities and risks presented by AI."[2]

Make talent, HCM, and CEO succession a priority.

Most companies have long said that their employees are their most valuable asset. COVID-19; the difficulty of finding, developing, and retaining talent in the current environment; and an increasingly knowledge-based economy have highlighted the importance of talent and HCM—and changed the employer/employee dynamic. This phenomenon of employee empowerment has prompted many companies and boards to rethink the employee value proposition.

While the most dramatic change in the employee value proposition took place during the pandemic, employee empowerment hasn't abated, and employees are demanding fair pay and benefits; work-life balance, including flexibility; interesting work; and an opportunity to advance. They also want to work for a company whose values—including commitment to DEI and a range of ESG issues—align with their own.

In 2023, we expect continued scrutiny of how companies are adjusting their talent development strategies to meet the challenge of finding, developing, and retaining talent amid a labor-constrained market. Does the board have a good understanding of the company's talent strategy and its alignment with the company's broader strategy and forecast needs for the short and long term? What are the challenges in keeping key roles filled with engaged employees? Which talent categories are in short supply and how will the company

[2] Avi Gesser, Bill Regner, and Anna Gressel, "AI Oversight Is Becoming a Board Issue," Debevoise & Plimpton LLP via HLS Forum on Corporate Governance, April 26, 2022.

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successfully compete for this talent? Does the talent strategy reflect a commitment to DEI at all levels? As millennials and younger employees join the workforce in large numbers and talent pools become globally diverse, is the company positioned to attract, develop, and retain top talent at all levels?

In addition to monitoring SEC and global rulemaking developments, boards should discuss with management the company's HCM disclosures in the 2022 10-K—including management's processes for developing related metrics and controls ensuring data quality—to help ensure that the disclosures demonstrate the company's commitment to critical HCM issues. HCM will likely be a major area of focus during the 2023 proxy season, given the high level of investor interest in the issue.

Pivotal to all of this is having the right CEO in place to drive culture and strategy, navigate risk, and create long-term value for the enterprise. The board should help ensure that the company is prepared for a CEO change—whether planned or unplanned, on an emergency interim basis or permanent. CEO succession planning is a dynamic, ongoing process, and the board should always be focused on developing a pipeline of C-suite and potential CEO candidates. Succession planning should start the day a new CEO is named.

How robust are the board's succession planning processes and activities? Has the succession plan been updated to reflect the CEO skills and experience necessary to execute against the company's long-term strategy? In many cases, those strategies have changed over the last two years. Are succession plans in place for other key executives? How does the board get to know the high-potential leaders two or three levels below the C-suite?

Engage proactively with shareholders, activists, and other stakeholders.

Two SEC developments will be important areas of board focus in upcoming shareholder and stakeholder engagements. Ahead of the 2023 proxy season, the SEC adopted a "pay versus performance rule" that requires detailed new disclosures in proxies and information statements for fiscal years ending on or after December 16, 2022. The SEC's universal proxy rules, which require the use of "universal" proxy cards in all director election contests, are already effective. The threat of universal proxy can serve as an important lever, encouraging greater focus on the skills and experience of individual directors and making it easier to launch a proxy fight.

Given the intense investor and stakeholder focus on executive pay and director performance, as well as climate risk, ESG, and DEI, particularly in the context of long-term value creation, engagement with shareholders *and* stakeholders must remain a priority. Institutional investors and stakeholders are increasingly holding boards accountable for company performance and are continuing to demand greater transparency, including direct engagement with independent directors on big-picture issues like strategy, ESG, and compensation. Indeed, transparency, authenticity, and trust are not only important to investors, but increasingly to employees, customers, suppliers, and communities—all of whom are holding companies and boards to account.

The board should request periodic updates from management about the company's engagement activities:

- Does the company know, engage with, and understand the priorities of its largest shareholders and key stakeholders?
- Are the right people engaging with these shareholders and stakeholders—and how is the investor relations (IR) role changing?
- What is the board's position on meeting with investors and stakeholders? Which independent directors should be involved?

In short: Is the company providing investors and stakeholders with a clear, current picture of its performance, challenges, and long-term vision—free of greenwashing? Investors, other stakeholders, and regulators are increasingly calling out companies and boards on ESG-related claims and commitments that fall short.

As reflected in 2022 proxy voting trends, strategy, executive compensation, management performance, climate risk, other ESG initiatives, DEI, HCM, and board composition and performance will remain squarely on investors' radar during the 2023 proxy season. We can also expect investors and stakeholders to focus on how companies are adapting their strategies to address the economic and geopolitical uncertainties and dynamics shaping the business and risk environment in 2023.

Having an "activist mindset" is as important as ever—particularly given the convergence of ESG and more traditional hedge fund activism as well as the universal proxy rules, which will enable activists to use the universal proxy card to gain leverage in their negotiations with boards.

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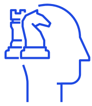

Think strategically about talent, expertise, and diversity in the boardroom.

Boards, investors, regulators, and other stakeholders are increasingly focused on the alignment of board composition—particularly director expertise and diversity—with the company's strategy.

Indeed, the increased level of investor engagement on this issue points to the central challenge with board composition: Having directors with experience in key functional areas critical to the business while also having deep industry experience and an understanding of the company's strategy and the risks to the strategy. It is important to recognize that many boards will not have "experts" in all the functional areas such as cybersecurity, climate, HCM, etc., and may need to engage outside experts.

Developing and maintaining a high-performing board that adds value requires a proactive approach to board-building and diversity—of skills, experience, thinking, gender, and race/ethnicity. While determining the company's current and future needs is the starting point for board composition, there is a broad range of board composition issues that require board focus and leadership—including succession planning for directors as well as board leaders (the lead director and committee chairs), director recruitment, director tenure, diversity, board and individual director evaluations, and removal of underperforming directors. Boards need to "tell their story" about the composition, skill sets, leadership, and functioning of the board and its committees.

Boards have made progress on diversity, but change has been slow. According to Spencer Stuart's 2022 S&P 500 Board Diversity Snapshot, 46% of the new directors added during the 2022 proxy season are Black/African American, Hispanic/Latino/a, Asian, American Indian/Native Alaskan, and multiracial directors, largely driven by an increase in the recruitment of Black/African American directors. And 46% of new directors are women. However, due to low boardroom turnover, the addition of new directors from underrepresented groups has had little impact on the overall diversity of S&P 500 boards. Just 22% of all S&P 500 directors in 2022 are from these underrepresented groups. And women now represent 32% of all S&P 500 directors.[3]

Board composition, diversity, and renewal should remain a key area of board focus in 2023, as a topic for communications with the company's institutional investors and other stakeholders, enhanced disclosure in the company's proxy, and most fundamentally positioning the board strategically for the future. ■

[3] Spencer Stuart, 2022 S&P 500 Board Diversity Snapshot, June 2022.

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On the 2023 audit committee agenda

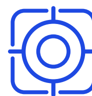
The business and risk environment has changed dramatically over the past year, with greater geopolitical instability, surging inflation, and the prospect of a global recession added to the mix of macroeconomic risks companies face in 2023.

Audit committees can expect their company's financial reporting, compliance, risk and internal control environment to be tested by an array of challenges in the year ahead—from global economic volatility and the Russia-Ukraine war to supply chain disruptions, cybersecurity risks and ransomware attacks, and social risks—including the tight talent market. The increasing complexity and fusion of risks, and the unexpected interconnectedness of these risks, put a premium on more holistic risk management and oversight.

In this volatile and opaque operating environment, demands from regulators, investors, and other stakeholders for action as well as increased disclosure and transparency—particularly around 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.**
- **Clarify the role of the audit committee in overseeing the company's climate and other ESG risks—particularly the scope and quality of ESG/ sustainability reports and disclosures.**
- **Maintain a sharp focus on leadership and talent in the finance organization.**
- **Reinforce audit quality and set clear expectations for frequent, candid, and open communications with the external auditor.**
- **Help ensure internal audit is focused on the company's key risks—beyond financial reporting and compliance—and is a valuable resource for the audit committee.**
- **Sharpen the company's focus on ethics, compliance, and culture.**
- **Stay apprised of global tax developments and risks and understand that tax has become an important element of ESG.**
- **Take a close look at the audit committee's composition and skill sets.**



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 company's 2022 10-K and 2023 filings should include:

Forecasting and disclosures: Making tough calls
The uncertainties posed by the current geopolitical, macroeconomic, and risk landscape, coupled with the extensive use of forward-looking information in financial statements and SEC filings, continue to make disclosures about matters that directly or indirectly impact the company's

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business a top area of focus. Among the matters requiring the audit committee's attention:

- 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
- Use of non-GAAP metrics.

With companies making more tough calls in the current environment, regulators are emphasizing 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.

In reviewing management's disclosures regarding these matters, consider the questions posed by the staff of the SEC's Division of Corporation Finance in its May 2022 sample comment letter pertaining to the Russia-Ukraine war and related supply chain issues. While the comment letter focuses on the direct and indirect effects of the war in Ukraine, the questions may be instructive in considering the company's disclosure obligations posed by the broader geopolitical, macroeconomic, and risk environment.

Internal control over financial reporting (ICOFR) and probing control deficiencies

Given the current geopolitical, macroeconomic, and risk environment, as well as changes in the business, such as acquisitions, new lines of business, digital transformations, etc., internal controls will continue to be put to the test in the coming year. Discuss with management how the current environment affects management's disclosure controls and procedures and management's assessment of the effectiveness of ICOFR. When control deficiencies are identified, it's important to probe beyond management's explanation for "why it's not a material 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?

Audit committee members continue to express concern that overseeing major risks on the 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 ESG risks have heightened concerns about audit committee bandwidth and "agenda overload." The SEC's proposed climate rules, if adopted, will add significantly to the workload of audit committees.

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.

Clarify the role of the audit committee in overseeing the company's climate and other ESG risks—particularly the scope and quality of ESG/sustainability reports and disclosures.

Intensifying demands for higher quality ESG disclosures should prompt boards to reassess their oversight of 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. With the SEC's rulemaking proposals for climate and cybersecurity disclosures, its anticipated SEC rulemaking on human capital disclosures, recent ESG-related SEC enforcement actions, and shareholder proposals on a broadening array of ESG issues, clarifying the audit committee's ESG responsibilities is critical.

Boards are taking various approaches to oversight of climate, cybersecurity, and other ESG risks. *Also see* On the 2023 board agenda *for a discussion of cybersecurity risk.* For many, that oversight is a full-board function, with much of the heavy lifting

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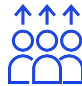
done at the committee level. The compensation, nom/gov, and audit committees all may have some responsibility. For example, the compensation committee may oversee human capital and executive compensation issues, and the nom/gov committee, or in some cases, a sustainability committee, may have general oversight responsibility for ESG. The audit committee typically has responsibility for overseeing ESG disclosures and disclosure frameworks, financial risks, legal/regulatory compliance risks, and perhaps the adequacy of the company's ERM processes generally.

With board standing committees playing a vital role in helping boards carry out their ESG oversight responsibilities, information sharing, communication, and coordination among committees and with the full board are essential. Given the financial reporting and internal control implications associated with ESG risks, the issue is particularly acute for audit committees. Audit committees need to recognize the input that other committees require, and those committees must appreciate the information needs of the audit committee. Key areas in which information sharing is critical include:

- Considering where ESG information is disclosed—e.g., sustainability reports, SEC filings, and company websites.
- Helping to ensure that ESG information that is voluntarily disclosed is subject to the same level of rigor as financial information, including disclosure controls and procedures.
- Selection of an ESG reporting framework(s). The SEC climate proposal is based in part on the Task Force on Climate-Related Financial Disclosures framework.
- Overseeing management's disclosure committee, including:
  - Clarifying the disclosure committee's role and responsibilities in connection with disclosures contained in SEC filings and those made voluntarily in sustainability reports, websites, etc.—including coordination with cross-functional management ESG team(s) or committee(s).
  - Reassessing the composition of the disclosure committee. Given the SEC's climate and cybersecurity proposals, and the intense focus on ESG, companies should consider expanding management's disclosure committee (or perhaps create a subcommittee) to include appropriate functional leaders, such as the chief sustainability officer, chief diversity officer, chief supply chain officer, and chief information security officer.
  - In preparation for the SEC's proposed climate disclosure rules, encouraging management's disclosure committee to work with management's ESG team or committee to identify gaps, consider how to gather and maintain quality information, and closely monitor the rulemaking process.
  - Expanding management's subcertification process to support CEO and CFO quarterly 302 certifications regarding design and operational effectiveness of disclosure controls and procedures (including internal controls).



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

Finance organizations face a challenging environment today—addressing talent shortages, while 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 and in preparation for potential SEC disclosure requirements. At the same time, many are contending with difficulties in forecasting and planning for an uncertain environment.

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

- Many finance organizations have been assembling or expanding management teams or committees charged with managing a range of ESG activities, including enhancing controls over ESG information being disclosed in sustainability reports, and preparing for the SEC's climate disclosure rules—e.g., identifying and recruiting climate and ESG talent and expertise, developing internal controls, and putting in place technology, processes, and systems.
  - Does the finance organization 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?

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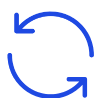
  - How far along is the finance organization in its preparations for new/ enhanced ESG disclosures?

- The acceleration of digital strategies and transformations that many companies are undertaking continues to affect finance organizations, presenting important opportunities for finance to add greater value to the business. 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 understanding finance's ESG reporting and digital transformation strategies and help ensure that finance has the leadership, talent, and bench strength to execute those strategies.



Reinforce audit quality and set clear expectations for frequent, candid, and open 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 2023, audit committees should discuss with the auditor how company's financial reporting and related internal control risks have 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.

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.

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 PCAOB inspections, Part I and Part II, 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.

Help ensure internal audit is focused on the company's key risks—beyond financial reporting and compliance—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. This means focusing not just on financial reporting and compliance risks, but on critical operational and technology risks and related controls, as well as ESG risks.

ESG-related risks are rapidly evolving and include human capital management—from DEI to talent, leadership, and corporate culture—as well as climate, cybersecurity, data governance and data privacy, and risks associated with ESG disclosures. 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 labor market, does internal audit have the talent it needs? Do management teams have the necessary resources and skill sets to execute new climate and ESG initiatives? Recognize that internal audit is not immune to talent pressures.

Given the evolving geopolitical, macroeconomic, and risk landscape, reassess whether the internal audit plan is risk-based and flexible enough to 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 risks that pose the greatest

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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 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 corporate culture?

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.

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 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.

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, and employee engagement and morale?

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 for 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 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? With 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 risks, and understand that tax has become an important element of ESG.

Disruption and uncertainty continue to describe the global tax environment today for corporations—particularly multinationals. On August 16, 2022, President Biden signed into law the Inflation Reduction Act (IRA), which includes a new 15% corporate alternative minimum tax on the income of larger corporations, creates a new excise tax on public corporation stock buybacks, and provides substantial additional funding for IRS enforcement, operations, and modernization. The IRA's new 15% alternative minimum tax is not the same as the 15% global minimum tax on multinational companies that the OECD proposed and that Treasury Secretary Janet Yellen encouraged countries to approve. At present, there is uncertainty as to how or whether the OECD countries will proceed to implement the 15% global minimum tax, as well as other tax initiatives, in light of the U.S. legislation.

Tax has also emerged as an important element of ESG, with stakeholders increasingly expecting companies to provide greater transparency and to conduct their tax affairs in a sustainable manner. 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. The FASB is expected to release draft rules for CbC reporting in the coming months and the SEC has signaled its support.

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In this environment, it is important for audit committees to engage with 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 not yet a 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 close 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 responsibility for financial reporting and control risks, the committee should revisit 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:

- Does the committee include members with the experience and skill sets necessary to oversee areas of risk (beyond its core responsibilities) that the audit committee has been assigned—such as cyber and data security, supply chain issues and geopolitical risk, ESG risks and disclosures, or climate?
- How many audit committee members spent their careers working on financial accounting, reporting, and control issues? Is the committee relying only on one member to do the "heavy lifting" in the oversight of financial reporting and controls? A dialogue among two or more committee members with a deep understanding of the issues is essential.
- As the audit committee's workload expands to include oversight of disclosures for nonfinancial 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. ■

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Financial reporting and auditing update

2022 AICPA & CIMA Conference highlights

In December, the AICPA and CIMA (Chartered Institute of Management Accountants) hosted their annual Conference on Current SEC and PCAOB Developments, which featured speakers from the SEC, FASB and PCAOB, and other key players in the financial reporting infrastructure. The overriding emphasis by SEC representatives was protecting investors through increased transparency in financial reporting and providing decision-useful information.

Key themes from the Conference included:

- **Quality amidst economic uncertainty.** SEC officials stressed the importance of disclosures about estimation uncertainties and the underlying basis for critical judgments, particularly in the current economic environment. Also top of mind at the SEC is a heightened risk of fraud and the need for professional judgment, particularly for companies involved in the crypto markets.
- **Transparency through disclosure.** Throughout the Conference, SEC officials commented on the need for disclosures to be company-specific, transparent, and effectively communicated to stakeholders. SEC staff also gave a nod to certain FASB projects geared toward greater investor transparency, such as the projects to improve income tax disclosures and disaggregating income statement line items.
- **The reporting landscape is changing.** Technology is rapidly changing the financial reporting and auditing functions, and cybersecurity is creating significant risk. A cybersecurity panel noted that as the use of digital technology expands, the "attack surface" also increases.
- **Emerging areas remain in the spotlight.** Other hot topics that were the focus of much discussion throughout the Conference included emerging areas such as ESG, crypto assets, and digitization.

The potential impacts of economic uncertainty on accounting and financial reporting

Significant economic uncertainty is resulting from the risks of a recession, rising interest rates, inflation, and geopolitical events. Although much of the focus has been on the economic impact of these macroeconomic trends and events, the accounting impacts cannot be overlooked.

Companies must consider the potential impact of recent trends and events on financial reporting, which may be broad. Areas of financial reporting that are frequently impacted by such events may include (but are not limited to) the following:

- **Nonfinancial asset impairment.** Goodwill and indefinite-lived intangible assets are tested for impairment annually or more frequently if there is a triggering event. Potential triggering events include a decrease in share price, increased cost of capital, limitations in a company's ability to pass on increased costs to customers, significant changes in circumstances, and downward trends in revenue or earnings projections.
- **Credit impairment.** Companies need to determine whether these trends and events have been considered in recognizing and measuring credit impairment under Topic 326 (credit losses) for recognized assets (such as loan receivables) and off-balance sheet exposures (such as unfunded loan commitments). Topic 326 requires companies to estimate the effect of current economic conditions and reasonable and supportable forecasts of future economic conditions and their effect on collectability.
- **Fair value measurement.** Economic uncertainty often causes investors to change their trading behavior in the securities markets. If economic trends and events cause the volume or level of activity for an asset or liability to significantly decrease, a company may have to further analyze

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the transactions or quoted prices to determine whether and how to use them as fair value inputs. In addition, these trends and events may impact a company's principal (or most advantageous) market determination for an asset or liability.

- **Debt arrangements.** A company may need to modify its debt arrangements if it is experiencing cash flow constraints that make it challenging to repay the debts or to comply with debt covenants (financial and nonfinancial). In this instance, not only does the company have to account for the debt modification, but it also may need to reconsider balance sheet classification of its debt as current or noncurrent.
- **Revenue recognition.** Continued supply chain and production disruptions can prompt changes in forecasts and create uncertainty for revenue transactions with customers. Companies should pay particular attention to customer credit risk, which affects receivables and contract assets, and potentially the timing and amount of revenue to be recognized in the future. Credit risk is also a factor in determining whether a contract with a customer exists under Topic 606 (revenue recognition).
- **Income taxes.** Companies that are experiencing significant unexpected ordinary losses (due to these trends/events) or capital losses (due to the effect of these trends/events on capital markets) may need to analyze whether those conditions result in the inability to realize deferred tax assets.
- **Financial statement disclosures.** In view of the uncertainty and complexity in forecasting and accounting for current and potential macroeconomic events, adequate disclosure in the financial statements is critical. These disclosures may be about the company's ability to continue as a going concern (Subtopic 205-40), risks and uncertainties (Topic 275), unusual items (Subtopic 220-20), and subsequent events (Topic 855). Companies are required to disclose matters that are reasonably likely to have a material impact on future results of operations or financial condition.

SEC developments on crypto assets

The staff of the SEC's Division of Corporation Finance released a sample letter containing illustrative comments that the SEC staff may issue to companies about the adequacy of their disclosures related to the direct or indirect impacts the recent widespread disruption in the crypto asset markets have had, or may have, on their businesses.

In the related release, the SEC staff advised companies that they should consider addressing crypto asset market developments in their filings generally, including in business descriptions, risk factors, and MD&A. The staff added that the comments in the sample letter "focus on the need for clear disclosure about the material impacts of crypto asset market developments, which may include exposure to counterparties and other market participants; risks related to a company's liquidity and ability to obtain financing; and risks related to legal proceedings, investigations, or regulatory impacts in the crypto asset markets."

ESG reporting update

SEC regulatory update

The SEC's Fall 2022 Regulatory Agenda (which sets anticipated rulemaking timelines through Fall 2023) shows the agency continuing with its ambitious pace and breadth of activity. The SEC has reviewed a multitude of comments letters, reopened certain comment periods (to ensure comments from all interested parties were received following a technological error), and in some cases, coordinated with other regulatory bodies and standards setters. Many of the long-anticipated rules now have target agenda dates of April 2023, including climate and cybersecurity.

SEC staff comment letters

Following a sample letter issued in September 2021, the Division of Corporation Finance continues to probe companies' climate-related disclosures. The SEC staff has sent approximately 70 letters (and counting) to companies, with the following key themes:

- Almost all companies were questioned on the extent of disclosure in their corporate social responsibility (CSR) report in comparison to disclosure their annual SEC filings. In most cases, companies explained the CSR report is for a larger stakeholder group than investors and the disclosures go beyond "investor materiality."
- The staff requested companies to quantify disclosures they consider to be immaterial such as carbon credits and climate-related capital expenditures.
- The staff asked many follow-up questions on transition and business risks. In some cases, companies agreed to update risk disclosures in their next annual filing.

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We are also seeing an emerging focus on governance disclosures, including how the board oversees climate risk.

SEC enforcement
The SEC's Division of Enforcement continues to make ESG a priority. In its press release on 2022 enforcement results, the SEC specifically called out ESG-related cases. Since its formation in March 2021, the Division's Climate and ESG Task Force has been involved in at least seven ESG-related enforcement actions. Division Director Gurbir Grewal has been reported as saying the SEC is not waiting for final rules to act; it is using existing rules to hold registrants accountable.

International Sustainability Standards Board (ISSB) developments
The ISSB has been redeliberating its proposals on (1) general sustainability-related matters and (2) climate-related matters, both of which were exposed for public comment in April. Recent meetings of the ISSB have provided directional insights on where the final standards may land—including keeping Scope 3 emissions disclosures in the final standards, and requiring the use of scenario analysis and maintaining the concept of investor materiality.

In November, CDP announced it will incorporate the ISSB's final climate standard into its environmental disclosure platform. This development is particularly significant for U.S. companies, many of whom are CDP members.

European Union developments
In November, the European Council unanimously approved the Corporate Sustainability Reporting Directive (CSRD), which will require expanded sustainability reporting for nearly 50,000 companies starting in fiscal 2024. Notwithstanding that the CSRD is an EU Directive, there are considerable ESG reporting implications for U.S. and other non-EU based companies.

In November, the European Financial Reporting Advisory Group (EFRAG) submitted its first set of draft European Sustainability Reporting Standards (ESRSs) to the European Commission (EC) for approval. The next step is for the EC to consider whether revisions are necessary ahead of expected final approval by June 30, 2023. EFRAG will now turn its attention to its second set of draft ESRSs, which include draft sector-specific standards; the final standards are expected to be adopted by the EC by June 30, 2024. ■

For more detail about these and other financial reporting and auditing issues, see the KPMG Q4 2022 Quarterly Outlook *and the BLC* On the 2023 audit committee agenda.

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Measuring what matters

Q&A with KPMG Chief Economist
Diane Swonk

Does Gross Domestic Product (GDP), the traditional measure of the economy's performance, still measure what matters? In today's more services-based economy—increasingly driven by hard-to-measure assets including people, goodwill, brand reputation, and intellectual property (IP)—is there an argument to be made for discarding traditional quantitative measures, like GDP, that focus primarily on industrial processes, in favor of qualitative measures that may better fit the longer-term value creation on which stakeholder capitalism is based?

KPMG Chief Economist Diane Swonk shares her thoughts on the use(fulness) of GDP and other potentially more insightful metrics, the challenges of forecasting in a world without precedents, and the value of "leaning into the humility of a forecast, while embracing the strength of scenarios."

Board Leadership Center (BLC): Strong GDP numbers always feel good, but how revealing is GDP of what's actually going on in today's economy, which is more services- and intangibles-based than the 20th century industrial economy that GDP was designed to measure?

Diane Swonk: The Commerce Department has gone to great lengths to upgrade and improve what GDP measures to better capture the world we are in, which is much more service-oriented than the world we left. They are also looking at high-frequency data and working with the large tech firms to better capture those shifts. One of the least-accredited but most useful measures the Commerce Department provided during the onset of the pandemic was the Household Pulse survey, which gave us a real-time look at how the pandemic was affecting households. Everything from child hunger to abilities to cover the basics of food and shelter to mental health were surveyed.

Those household metrics were critical, and some of the lessons learned will be incorporated into GDP going forward. Still, the world is in a revolution of information and change, while the GDP stats tend to evolve slowly over time; the government is always chasing a moving target on getting GDP measures to more accurately reflect what is actually happening.

I don't think a lot of people are aware of the many efforts that have and will continue to improve the GDP stats. The top economists in the country on technology and innovation are working on improving those measures. GDP isn't perfect, but it's much more nuanced than it once was.

The hardest thing to measure is the productivity growth associated with the technology revolution and the digitization of the economy. GDP data measures what we actually spend on, versus the how of the economic activity and growth—which is about more than just the pivot from goods to services.

A better measure of overall growth within the index is GDI, or Gross Domestic Income. The divergence between that and GDP in the first half of 2022 illustrated the gaps in the GDP figures for the overall economy. That was unusual, and reflected the impact of the Russia-Ukraine war on the rest of the world compared to the U.S. We held up better, but GDI still decelerated over the course of 2022 relative to 2021. Even employment, which was still stunningly strong in 2022, slowed relative to the surge when the economy more fully reopened in 2021.

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BLC: Are there other measures or frameworks that more effectively show how the economy is benefitting people's lives? Would markets become more efficient with better information and metrics around economic well-being at a more granular level?

Diane: We have seen both the power and the shortfall of high-frequency data during the pandemic. I don't think many people watched the daily Transportation Security Administration (TSA) throughput data or the OpenTable reservations data prior to the pandemic. The frequency of the data is its strength and weakness. The same is true of daily credit card data. Bad weather can distort any given day.

Much of the high-frequency data lacks the history to accurately assess what it actually means, while cleaning the data of noise and seasonally adjusting a series that may be in response to a pandemic-induced bubble, such as the pivot to spending online, is tricky.

Consumers are likely to spend more online going forward, but not like they did at the height of quarantines. Online shopping is so ubiquitous now that it will soon be folded into the overall retail sales data and not a separate line item.

As to whether high-frequency data makes the market more efficient, I have my doubts. The data is noisy. Private-sector data can be manipulated or discontinued when the data providers do not like the story it is telling, and is not necessarily predictive. It could actually add to market volatility unnecessarily. What is useful for a company to know about its own orders and how it plans to adjust may not be the same way financial markets guess what the impact on profits may be.

It is also important to have reliable sources of data that can be revised to be more accurate but also transparent in methodology and how it is put together. Government metrics that leverage high-frequency data and more digital data, including inflation measures, must reveal all of that. Private-sector sources do not. The government is even forced to disclose any major revisions or shifts in source data and methodology.

BLC: Given the shift to remote work, the focus on energy transition, and other post-pandemic curveballs, are we in uncharted territory when it comes to certain economic metrics and forecasting? What do you see economists and corporate leaders wrestling with most today?

Diane: The metrics that we have are capturing much more than people realize. That said, we need to and we can always do better. As for forecasting, this is the toughest part. First, there is no precedent or historical norms to leverage in the data. And second, it is extremely hard to figure out seasonal adjustment of data in world that has different seasons due to climate change than it once did and is more reflective of residue of pandemic and war distortions than a change in the seasons. The latter includes hiring and spending during the holiday season.

Most people do not realize that the National Oceanic and Atmospheric Administration (NOAA) is housed within the Department of Commerce to better connect the thinking around climate and the economy. That is important.

The hardest issue that business leaders and economists wrestle with is forecasting in a world with no precedent and so much uncertainty and volatility. I have found it much more useful to merge more intel on geopolitics, climate, demographics, sociologists, and related professionals and all kinds of medical research.

People lose sight of the obvious. The health of any economy is inherently dependent on the health of its people. Moreover, physical and mental health are intimately intertwined and can supplement or undermine productivity growth.

Wages and benefits are only the table stakes. In one study that I analyzed with a former colleague, we that found employee retention rates in a hospital system could be boosted dramatically by providing the employees' families with access to the experts they worked for. Engagement boosts productivity growth, but we can't guess what workers want. The studies I have seen by managers and HR professionals suggest they are poor at guessing.

Too often, we impose our own ideological bias versus actually gathering the information on what will improve engagement and retention. The data is telling, but only if you ask the correct questions of it.

BLC: Do you see AI or other technologies playing a role in getting a better, more real-time view of what's going on in the economy—e.g., enabling more focus on leading versus lagging indicators? Generally speaking, is economic forecasting becoming more precise?

Diane: AI is improving and has extraordinary potential to bridge skills gaps and boost both productivity and wages in ways we once only imagined.

Thus far, it has not been able to predict and has led to some very wrong predictions as it is subject to the same biases or even more, given how narrow the demographics of those who write AI programs can

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be. There have been gross errors in healthcare and criminal justice that have exacerbated inequality and made it harder for the economy to perform well.

We need to be aware of this. We got lulled into a similar false narrative on economic modeling more than half a century ago as economists shifted from modeling out the economy and behavioral responses on paper and in theory to modeling with statistics that do not fully capture behavioral shifts. Again, nuance is key.

The hardest part of my job is leaning into the humility of a forecast, while embracing the strength of scenarios. A mentor taught me many years ago that economists are asked the wrong questions. It is our job to reframe the debate on longer term issues—which economics, when paired with the work of other fields, is much better at.

BLC: Similar to the GDP question, is there a case to be made at a company-level for thinking differently about quarterly earnings versus other measures of corporate performance and value creation? Are quarterly earnings becoming a relatively "blunt indicator" of value creation and a company's longer-term well-being?

Diane: Trust in institutions has been eroding for decades. It is at a really low level and that includes large, publicly traded companies and the gap between owners of capital and workers.

Companies report, and the economic research validates, that they do better profit-wise when they are more focused on what were once considered social or government problems, such as ESG. There is a huge need to solidify targets so that companies can report across a broader spectrum of results and show the correlation with profits. It has also proven key to recruiting and retaining the best talent.

BLC: Is there a specific metric that you have found to be surprisingly illuminating—and that tends to generate a particularly rich discussion—when it's raised in a boardroom conversation?

Diane: I am always surprised by how little is understood about the data that companies and boards are looking at—what is shaping it and how it is compiled. And that includes government and firm data. It's one reason tech companies are now the largest employer of economists. Trying to better understand AI beyond correlation to causality, for example. Asking the right questions is the key—and it's not easy.

BLC: At a macro level, when you think about economic progress and prosperity, are there two or three trends that you're particularly optimistic or concerned about?

Diane: Inequality is destabilizing and non-productive. How we equalize the economy across a broad spectrum of metrics is critical. We need to invest and enhance the earning power of workers, which spans shifts in education, access to transit, healthcare, and childcare.

I am stunned by how cavalier organizations can be about retaining talent. I, myself, fit into many boxes and faced significant hurdles that often hold people back, including having dyslexia. I also know that it is one of many things that made me resilient, tenacious, and someone who thinks outside of the box.

We are all more comfortable being around those who are more similar than different, but the longer we deliberate the facts and think through scenarios with a much more diverse set of leaders, the better the outcome. It is in this discomfort that we get to deeper insights and better decisions.

BLC: "Sustainable growth" and even "de-growth" have joined the macroeconomic debate alongside the "all growth is good" point of view. Does corporate America have a role to play in influencing how we think about and measure growth and economic well-being going forward?

Diane: Corporate America has a huge role to play in understanding the economy and how we measure growth. Advocating for quality data and data lending—which many firms do—to enhance the quality of the data that the government is provided with is critical.

Well-being is another measure that goes well beyond GDP statistics. That large firms are participating in economic research on the role that mental and physical health, and empathetic managers, play in promoting retention and productivity at their companies has also contributed to huge leaps in our understanding of the economy. ■

Read more from Diane Swonk and KPMG Economics.

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BLC Quarterly Webcast

January 19, 11 a.m.–12 p.m. EST

Join KPMG LLP Chief Economist Diane Swonk and KPMG BLC Leader John Rodi for a discussion on the outlook for the U.S. and global economies in the upcoming year, including trends and challenges shaping corporate growth, employment, trade, and the general operating environment amid political and market volatility around the world.

For more information, visit watch.kpmg.us/BLCwebcast.

On the 2023 Board Agenda Webcast

February 2, 11 a.m.–12 p.m. EST

Join the KPMG BLC team of senior advisors for a special webcast featuring a conversation on the challenges and priorities shaping boardroom agendas in 2023.

For more information, visit watch.kpmg.us/BLCwebcast.

KPMG Board Insights Podcast

On demand

Conversations with directors, business leaders, and governance luminaries to explore the emerging issues and pressing challenges facing boards today.

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Selected reading

Board diversity disclosure: The time is now
KPMG BLC via NACD

Audit committee transparency barometer
The Center for Audit Quality

Preparing for cybersecurity regulations
Harvard Business Review

Trickle-down effect of board diversity
The National Law Review

The supply chain trends shaking up 2023
KPMG LLP

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