On the 2024 audit committee agenda

KPMG Board Leadership Center

The business and risk environment has changed dramatically over the past year, with greater geopolitical instability, surging inflation, high interest rates, and unprecedented levels of disruption and uncertainty. Audit committees can expect their company's reporting, compliance, risk, and internal control environment to be put to the test by an array of challenges – from global economic volatility and the wars in Ukraine and the Middle East to cybersecurity risks and ransomware attacks as well as preparations for climate and sustainability reporting requirements, which will require developing related internal controls and disclosure controls and procedures.

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 2024 agendas

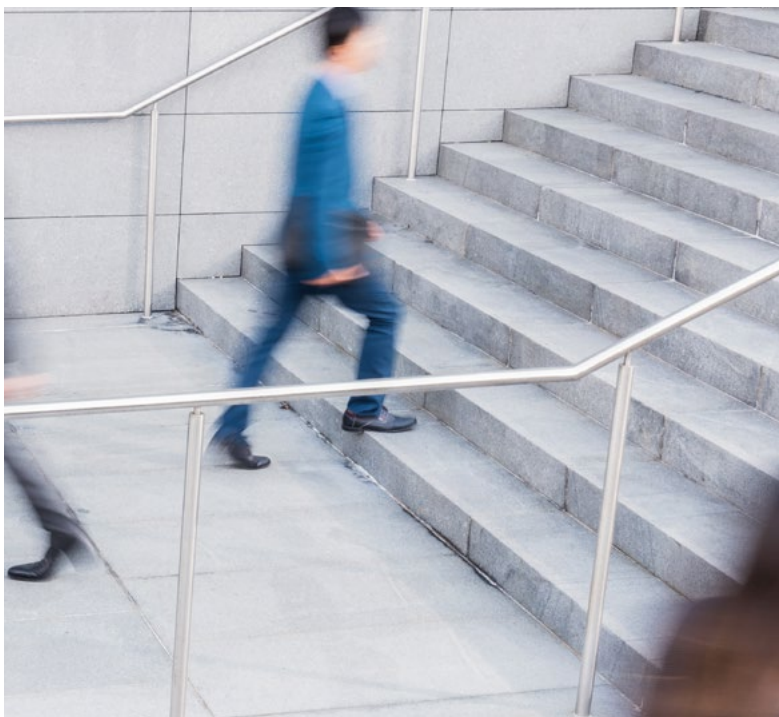
Stay focused on financial reporting and related internal control risks – job number one

Focusing on the financial reporting, accounting and disclosure obligations posed by the current geopolitical, macroeconomic and risk landscape will be a top priority and major undertaking for audit committees in 2024. Key areas of focus should include:

Forecasting and disclosures

Among the matters requiring the audit committee's attention: disclosures regarding the impact of the wars in Ukraine and the Middle East, government sanctions, supply chain disruptions, heightened cybersecurity risk, climate change, inflation, interest rates, market volatility and the risk of a global recession; preparation of forward-looking cash-flow estimates; impairment of non-financial assets, including goodwill and other intangible assets; the impact of events and trends on liquidity; accounting for financial assets (fair value); going concern; and 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.



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

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 put ICOFR to the test. Discuss with management how the current environment and regulatory mandates – including new climate rules – affect management's disclosure controls and procedures and ICOFR, as well as management's assessment of the effectiveness of ICOFR.

Probe any control deficiencies identified and help provide a balanced evaluation of the deficiency's severity and cause. Is the audit committee – with management – regularly taking a fresh look at the company's control environment? Have controls kept pace with the company's operations, business model and changing risk profile, including cybersecurity risks? Does management talk the talk and walk the walk?

Importance of a comprehensive risk assessment

The importance of a comprehensive risk assessment should not be underestimated. Help ensure that management is not too narrowly focused on information and risks that directly impact financial reporting while disregarding broader, entity-level issues that may also impact financial reporting and internal controls.

Committee bandwidth and skillsets

The audit committee's role in overseeing management's preparations for new climate and sustainability reporting requirements further expands the committee's oversight responsibilities beyond its core oversight responsibilities (financial reporting and related internal controls, and internal and external auditors). This expansion should heighten concerns about audit committee bandwidth and "agenda overload."

Reassess whether the committee has the time and expertise to oversee the major risks on its plate today. Such a reassessment is sometimes done in connection with an overall reassessment of issues assigned to each board standing committee. For example, do cybersecurity, climate, ESG or "mission-critical" risks such as safety, as well as artificial intelligence (AI), including generative AI, 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, climate/sustainability, or other committee – and perhaps the need for directors with new skillsets – would improve the board's effectiveness can be a healthy part of the risk oversight discussion.

Maintain focus on cybersecurity and data privacy

Cybersecurity risk continues to intensify. The acceleration of AI, the increasing sophistication of attacks, the wars in Ukraine and the Middle East, and ill-defined lines of responsibility – among users, companies, vendors, and government agencies – have elevated cybersecurity risk and its place on board and committee agendas.

The growing sophistication of the cyber threat points to the continued cybersecurity challenge – and the need for management teams and boards to continue to focus on resilience. Breaches and cyber incidents are going to happen, and organizations must be prepared to respond appropriately when they do. In other words, it's not a matter of if, but when.

Regulators and investors are demanding transparency into how companies are assessing and managing cyber risk and building and maintaining resilience. For example, the SEC now requires public companies to disclose material "cybersecurity incidents" within four business days.

While data governance overlaps with cybersecurity, it's broader and includes compliance with industry-specific laws and regulations as well as privacy laws and regulations that govern how personal data – from customers, employees or vendors – is processed, stored, collected and used. 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 reputational and trust risks for companies and is a critical leadership challenge. How robust and up-to-date is management's data governance framework? Does it address third-party cybersecurity and data governance risks?

Cyber threats should be considered as part of the company's risk management process, and the audit committee should test whether the company has:

- Identified the critical information assets which it wishes to protect against cyber attack – the crown jewels of the firm – be it financial data, operational data, employee data, customer data or intellectual property.
- Intelligence processes in place to understand the threat to the company's assets, including its overseas operations.
- A method of identifying and agreeing the level of cyber-attack risk that the company is prepared to tolerate for a given information asset.
- Controls in place to prepare, protect, detect and respond to a cyber attack – including the management of the

consequences of a cyber security incident.
- A means of monitoring the effectiveness of its cyber security controls, including where appropriate, independently testing, reviewing and assuring such controls.
- A programme of continuous improvement, or where needed, transformation, to match the changing cyber threat – with appropriate performance indicators.

Clarify roles ahead of new climate, sustainability, and other ESG disclosures – and oversee the quality and reliability of the underlying data

As discussed in "On the 2024 board agenda", an important area of board focus and oversight will be management's efforts to prepare for dramatically increased climate and ESG disclosure requirements in the coming years.

Swiss legislation requires listed companies to publish their first non-financial report for the 2023 financial year. The content of such a report is structured based on the EU's Non-financial Reporting Directive (NFRD) adopted in 2014. There is no requirement to audit the non-financial report. On 22 September 2023, the Swiss Federal Council announced by mid-2024 a draft to change this legal requirement in the following way: Align the content of the non-financial report with international standards, namely the EU's Corporate Sustainability Reporting Directive (CSRD), and make it subject to mandatory assurance (limited first, reasonable at a later stage, as required by the EU).

Companies with major business operations in Europe are also assessing the potential effects of, and preparing to apply, the European Sustainability Reporting Standards (ESRSs) issued under the Corporate Sustainability Reporting Directive (CSRD) in the EU, and IFRS Sustainability Disclosure Standards issued by the ISSB. Especially ESRSs are highly prescriptive and expansive. The CSRD also includes a requirement for large non-EU companies that operate in the EU to provide sustainability reporting.

Also, under the SEC's proposed climate disclosure rule, companies, including foreign registrants, will need to provide an account of their greenhouse gas (GHG) emissions, the environmental risks they face, and the measures they're taking in response. Crucially, according to the proposed rule, issuers will be subject to mandatory limited assurance initially, with mandatory reasonable assurance being phased in for accelerated and large accelerated filers. In addition, some information will need to be disclosed in the notes to the financial statements.

Companies will need to keep abreast of ongoing developments and determine which standards apply, and the level of interoperability of the applicable standards. For example, there are different materiality thresholds. The ISSB considers financial materiality — in which information is material if investors would consider it important in their decision-making — whereas the EU uses the concept of "double materiality", through the lenses of the financial effect on the company and the impact the company has on the wider community and environment.

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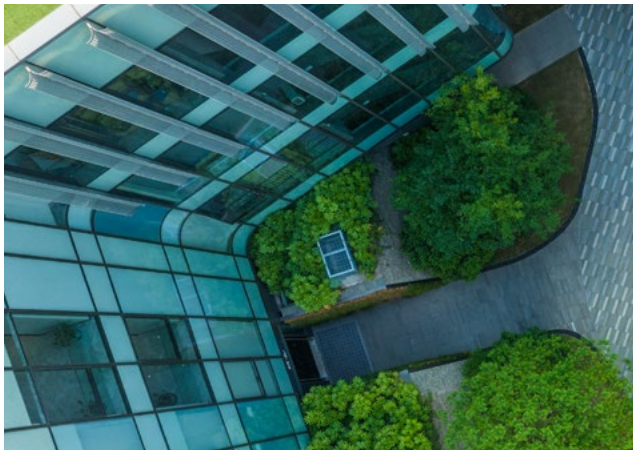
A key area of board and audit committee focus will be the state of the company's preparedness – requiring periodic updates on management's preparations, including gap analyses, materiality assessments, resources, assurance readiness and any new skills needed to meet regulatory deadlines.
In addition to the compliance challenge, companies must also ensure that disclosures are consistent, and consider the potential for liability posed by detailed disclosures.

Given the scope of the effort, audit committees should encourage management to prepare now by assessing the path to compliance with applicable reporting standards and requirements – including the plan to develop high quality, reliable climate and sustainability data. Key areas of audit committee focus should include:

- Clarifying internal roles and responsibilities in connection with the disclosures in the annual report and accounts, other regulatory reports and those made voluntarily in sustainability reports, websites, etc. – including



coordination between any cross-functional management ESG team(s) or committee(s).

- Ensuring management have processes in place to review the disclosures, including for consistency with the annual report and accounts. Making sure the teams looking at ESG issues/reporting are properly connected to the core finance function is important.
- Helping to ensure that ESG information being disclosed is subject to the same level of rigor as financial information – meaning disclosure controls and procedures. Given the nature of the climate, sustainability, and ESG reporting requirements and the intense focus on these disclosures generally, companies should consider enhancing management's disclosure processes to include appropriate climate, sustainability, and other ESG functional leaders, such as the ESG controller (if any), chief sustainability officer, chief human resources officer, chief diversity officer, chief supply chain officer, and chief information security officer.
- Encouraging management to identify any gaps in governance and consider how to gather and maintain quality information. Also, closely monitor Swiss and international rulemaking activities.
- Understanding whether appropriate systems are in place or are being developed to ensure the quality of data that must be assured by third parties.

Reinforce audit quality

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 2024, audit committees should discuss with the auditor how the company's financial reporting and related internal control risks have changed in light of the geopolitical, macroeconomic, regulatory and risk landscape, as well as changes in the business.

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 such as AI to drive audit quality.

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

Looking more widely, ask are we "doing the right thing?" Many companies are thinking about how they are perceived by shareholders and other stakeholders. This is empowering some audit committees to extend the independent (external) assurance they receive – whether from the external auditor or other third party assurance providers.

Be aware of capacity constraints within the audit profession. Think ahead if an audit tender is due or planned – getting the "right" auditor may be more difficult than expected. With audit tenders typically being carried out two years ahead of the transition date, the time to plan, build relationships, and determine which firms should take part in the tender might need to start much earlier than first thought.

Make sure internal audit is focused on the company's key risks and is a valuable resource to the audit committee

As audit committees wrestle with heavy agendas – and risk management is put to the test – internal audit should be a valuable resource for the audit committee and a critical voice on risk and control matters. This means focusing not only on financial reporting and compliance risks, but also 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 diversity, equity and inclusion 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 enterprise risk management more generally – which is not to manage risk, but to provide added assurance regarding the adequacy of risk management processes. Do management teams have the necessary resources and skill sets to execute new climate and ESG initiatives?
Reassess whether the internal audit plan is risk-based and flexible enough to adjust to changing business and risk conditions. The audit committee should work with the head of internal audit and chief risk officer to help identify the risks that pose the greatest threat to the company's reputation, strategy, and operations, and to help ensure that internal audit is focused on these key risks and related controls.

These may include industry-specific, mission-critical and regulatory risks, economic and geopolitical risks, the impact of climate change on the business, cybersecurity and data privacy, risks posed by generative AI and digital technologies, talent management and retention, hybrid work and organizational culture, supply chain and third-party risks, and the adequacy of business continuity and crisis management plans.

Given internal audit's broadening mandate, it will likely require upskilling, like the finance organization. Set clear expectations and help ensure that internal audit has the talent, resources, skills and expertise to succeed – and help the head of internal audit think through the impact of digital technologies on internal audit.

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

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

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 the ESG information being disclosed in corporate reports. Does the finance organization have the leadership, talent, skillsets and other resources necessary to address climate and other ESG reporting and to ensure that quality data is being collected and maintained? Has adequate consideration been given to the diversity of the team and the pipeline? How far along is the finance organization in its preparations for any new/enhanced ESG disclosures?
- At the same time, the acceleration of digital strategies and transformations, presents important opportunities for finance to add greater value to the business. The finance function is combining strong analytics and strategic capabilities with traditional financial reporting, accounting, and auditing skills.

It is essential that the audit committee devote adequate time to understanding finance's climate/sustainability/ESG strategy and digital transformation strategy and help ensure that finance is attracting, developing and retaining the leadership, talent, skillsets and bench strength to execute those strategies, as well as its existing responsibilities. Staffing deficiencies in the finance department may pose the risk of internal control deficiencies.

Help sharpen the company's focus on ethics, compliance, and culture

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

Fundamental to an effective compliance program is the right tone at the top and culture throughout the organization, including commitment to its stated values, ethics and legal and 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? Leadership, communication, understanding, and compassion are essential. Does the company's culture make it safe for people to do the right thing? It is helpful for directors to spend time in the field meeting 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 whistleblower 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.

Clarify oversight of generative AI

As discussed in "On the 2024 board agenda", the monitoring of generative AI will be an oversight priority for almost every board in 2024.

As with ESG, the oversight of generative AI may involve multiple committees, and the audit committee may end up overseeing compliance with the patchwork of differing laws and regulations governing generative AI, as well as the development and maintenance of related internal controls and disclosure controls and procedures.

Some audit committees may have broader oversight responsibilities for generative AI, including oversight of various aspects of the company's governance structure for the development and use of the technology.

How and when is a generative AI system or model – including a third-party model – developed and deployed, and who makes that decision? What generative AI risk management framework is used? Does the organization have the necessary generative AI-related talent and resources?

Given how fluid the situation is – with generative AI gaining rapid momentum – the allocation of these oversight responsibilities to the audit committee may need to be revisited throughout the year.

About the KPMG Board Leadership Center

The KPMG Board Leadership Center offers support and guidance to board members. We equip you with the tools and insights you need to be highly effective in your role, enabling you to focus on the issues that really matter to you and your business. In addition, we help you to connect with peers and exchange experiences.
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