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On the 2020 Banking Industry Audit Committee Agenda

Prioritizing a bank's heavy audit committee agenda is never easy, and 2020 will be particularly challenging. Banks and their audit committees are operating against a backdrop of rapid technological advances and pressing demands by (i) customers for faster, more multi-faceted experiences and (ii) regulators for continuously improving controls and risk management. At the same time, industry developments—new accounting standards (credit impairment standard), the upcoming payment-modernization standard, and the eventual elimination of the London Inter-bank Offered Rate (LIBOR)—are also increasing the burden.

Finally, and maybe most important, are questions about whether audit committees and management are having discussions about how banks are planning for the inevitable turn in the credit cycle. If credit suddenly tightens, are banks ready? How will they respond? These and other key challenges are creating another busy and complicated year for bank audit committees.

Drawing on insights from several KPMG studies, along with our professionals' frequent interactions with banks' audit committee members and senior management, we have flagged a series of issues that we recommend audit committees keep in mind as they consider and carry out their 2020 duties:

- Take control of the audit committee's agenda.
- Reinforce audit quality and set clear expectations for the external auditor.
- Understand the impact that technology is having on the finance organization's talent, efficiency, and value.
- Focus on "Day 2" impacts of the Current Expected Credit Losses (CECL) standard.
- Redouble focus on the company's ethics, compliance, and whistleblower programs.
- Help to ensure that internal auditors' focus is guided by an appropriate risk assessment.
- Scan the horizon for emerging issues.

Take control of the audit committee's agenda.

For a number of years now, KPMG has been reporting that audit committee members have expressed concern that their agendas—beyond their core financial reporting, internal control, and internal- and external-auditor oversight mandates—may be too crowded, risking overall effectiveness.

The risks that many audit committees are now overseeing—those associated with financial reporting, cybersecurity, and information technology; third-party arrangements, operational effectiveness; legal and regulatory compliance—have become much more complex as time has passed.

We believe bank audit committees may need to step back and evaluate whether some of the agenda items fit their mandate and members' capabilities; whether committee members have the expertise (or the time) to oversee the risks that have been assigned to them. Members may need to ask: Do cyber-risk and data-governance matters require greater attention from the full board—or, perhaps a dedicated board committee? We suggest audit committees consider whether it is prudent to limit their responsibilities to the oversight of timely escalation, accounting, and disclosure of cyber security issues to the appropriate internal and external parties.

The same question about audit-committee or full-board oversight could be raised about information technology and other risks. The use of more powerful and insightful technologies in the finance function (such as incorporating automation to reduce human-error possibilities) may be an area where the audit committee needs assistance. Even while evaluating which duties to keep on the agenda and which to remove, we also believe audit committees must understand management's strategic plans to compete and grow. The question must be asked: Does the strategy create an environment to take on competitors and grow while avoiding unnecessary risks? Are the resulting risks adequately incorporated into management's judgmental accounting estimates and disclosures?

Reinforce audit quality and set clear expectations for the external auditor.

Audit committees should pay special attention to a December 30, 2019 "public statement" from the Securities and Exchange Commission (SEC)[1] that is meant as a "reminder" of a list of essential issues the SEC expects audit committees to monitor and understand in their oversight role in financial reporting. The statement articulates how the SEC expects external auditors to communicate with audit committees. The statement also refers to other areas of focus, including tone at the top, and:

— auditor independence;

— the responsibility of audit committees to promote an environment for management's successful implementation of new accounting standards;

— the importance of understanding management's assessment of internal control over financial reporting;

— the implementation of reference-rate reforms related to LIBOR;

— the Critical Audit Matters (CAM) included in the auditor's report—focusing investors and audit committees on the audit's especially challenging, subjective, or complex matters.

Audit committees also are reminded to pay close attention to the Public Company Accounting Oversight Board's (PCAOB) quality control initiatives, as the PCAOB staff has announced that it is developing a concept release for the board's consideration and may seek amendments to the PCAOB's quality control standard. 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 and internal inspections and efforts to address deficiencies. During 2019, the PCAOB spoke to nearly 400 audit committee chairs and recently shared perspectives from those conversations about what is working well to help improve audit quality.[2] Remember that audit quality is a team effort, requiring the commitment and engagement of everyone involved in the process—the auditor, the audit committee, and management.

Understand the impact that technology is having on the finance organization's talent, efficiency, and value.

Digitization and automation within the finance function is increasingly critical to a bank's effectiveness. There are many technology changes that present significant opportunities for the finance function to add greater value to management and to the overall organization. As audit committees monitor and help guide finance's progress in this area, we suggest three areas of focus. First, recognizing that as much as 80 percent of finance's work involves data gathering, what is the organization's plan to leverage robotics and cloud technologies to automate as many manual, data-related activities as possible? These enhancements have the potential to reduce costs and improve quality if managed well. However, a word of warning is warranted: Are management's cost objectives inadvertently cutting into muscle (e.g., control quality) in its zeal to trim fat? Second, how will finance use data analytics to develop sharper insights and better decision-making? The finance function is well-positioned to guide the company's data and analytics agenda and to consider the implications of new transaction-related technologies, like blockchain. As historical analysis becomes more automated, the bank's analytics capabilities should evolve to include predictive analytics, as an important opportunity to add real value. Third, as the finance function combines strong analytics and strategy capabilities with traditional reporting, accounting and auditing skills, its talent and skill-set requirements must change accordingly. Is finance attracting, developing,

[1] *"Statement on Role of Audit Committees in Financial Reporting and Key Reminders of Oversight Responsibilities," Securities and Exchange Commission, Dec. 30, 2019* https://www.sec.gov/news/public-statement/statement-role-audit-committees-financial-reporting

[2] *"Conversations With Audit Committee Chairs: What we Heard and FAQs," Public Company Accounting Oversight Board,* https://pcaobus.org/Documents/Conversations-with-Audit-Committee-Chairs.pdf

and retaining the talent and skills necessary to match its evolving needs? In this environment, it is essential that the audit committee devote adequate time to understand finance's transformation strategy. This point raises some essential areas to question: Determine if your finance organization is handling the rapid digitization of the finance function in a strategic fashion? Is operational excellence something that the business is striving to achieve? Answering those questions is critical if the business is to remain competitive in the marketplace and service customers in the way they want to be serviced.

Focus on "Day-2" impacts of the CECL standard.

Bank audit committees will now need to focus on how management is handling "Day 2" accounting, planned disclosures, internal controls, and any adjustments to key performance indicators. Accounting for CECL was adopted by the larger calendar year-end public banks effective January 1, 2020, and now audit committees will need to understand and monitor some of the business-as-usual aspects of the standard. For example, how are banks forecasting processes being adjusted to reflect the expected increased income statement volatility of the new standard? Does the bank plan to provide new non-GAAP measures to enhance communications with investors and, if so, how has the bank considered the recent SEC cautions around non-GAAP measures? There are also some interesting business questions audit committees might want to understand as well, including: Does the bank plan to change loan structures (e.g., shorten terms) or pricing as a result of CECL? In addition, there are important issues related to the interplay between purchase accounting in a business combination and the ongoing credit impairment that would be important for audit committees to understand. Finally, audit committees should monitor the impact on internal controls over financial reporting including controls over new data used in the estimation process and in disclosures.

Redouble focus on the company's ethics, compliance, and whistle blower programs.

The reputational costs of an ethics or compliance failure are higher than ever. Fundamental to an effective compliance program is the proper tone at the top and a focus on a culture throughout the organization of doing the right thing at all times. The culture must support the company's strategy, including its commitment to its stated values, ethics, and legal/regulatory compliance. These mandates are particularly true in a complex business environment, as companies move quickly to innovate and capitalize on opportunities in new markets, leverage new technologies and new sources of data, and engage with more vendors and third parties. Coupled with a challenging global regulatory environment, compliance risks and vulnerabilities will require vigilance. Closely monitor the tone at the top and culture throughout the organization with a sharp focus on behaviors (not just results) and red flags. Does the company's culture make it safe for people to do the right thing? Help ensure that the company's regulatory compliance and monitoring programs are up to date, covers all vendors, and clearly communicates the company's expectations for high ethical standards. Focus on the effectiveness of the company's whistleblower reporting channels 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? As a result of the radical transparency enabled by social media, the company's culture and values, commitment to integrity and legal compliance, and brand reputation are all on full display.

Help to ensure that internal auditors' focus is guided by an appropriate risk assessment.

Aside from financial reporting risk issues, and issues that can damage a company's reputation due to cultural and compliance failures, internal audit's mandate is changing. Audit committees must be vigilant (but not bogged down) on these additional issues and must monitor internal audit's plan to ensure they do not lose focus on financial reporting risks as a result of addressing other risks. The audit committee should work with the chief audit executive and chief risk officer to help identify whether the audit plan is risk-based and flexible—and whether it can adjust to changing business and risk conditions. 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? What role should internal audit play in auditing the culture of the company? Set clear expectations and help ensure that internal audit has the resources, skills, and experience to succeed. What work is management doing to promote agility and build the internal audit workforce of the future?

Scan the horizon for emerging issues.

While KPMG believes it is vital for audit committees to manage the agenda in a way that allows its members to avoid being saddled with too many duties, we also believe that it is important for committee members to keep future challenges and opportunities in mind.

We've identified a few items that are potentially impactful with respect to the bank's effectiveness and profitability—as well as its ability to remain in compliance with regulatory requirements:

Living without LIBOR

Well before the calendar flips to January 1, 2022—when LIBOR will no longer be the reference interest rate pegged to myriad financial instruments—banks and other financial institutions will need to be far along with the task of making this historic change. In fact, in our view, if banks have not started on this task, audit committees should insist that the time is now. Banks that are behind are risking not being well-prepared to manage the transition's complexities and risks.

Reassess the scope and quality of the environmental, social, and governance (ESG) sustainability reports and disclosures.

Larger banks, along with nearly all Standard & Poor's 500 companies provide some form of ESG or sustainability reports today, but there are growing concerns by a range of stakeholders—investors, employees, customers, regulators, and activists—regarding the quality, comparability, reliability, and usefulness of these reports. Therefore, there is a demand that businesses, including banks, meet expectations and demands that ESG reports are useful and transparent. We believe audit committees can act as catalysts in this area by asking for updates from management and building their understanding of how the market is reacting. Transparent reporting may be a significant undertaking and would likely include benchmarking against peers, considerations of the methodologies and standards of various firms that rate banks on ESG practices, understanding the expectations of investors and other stakeholders, and reviewing various ESG frameworks. Management's disclosure committee may eventually play a part of these disclosure discussions to help ensure that the company has the necessary infrastructure—including disclosure controls and procedures—to support its ESG reporting.

ISO 200022—A payments modernization standard is on the way

A payments modernization standard is in the offing, and it promises to quickly become the global language for financial messaging. Industry mandates and challenges with existing legacy environments are accelerating the adoption of the ISO 200022 standard in markets globally. Understanding the impacts and developing a thoughtful roadmap and approach to implementation is critical to becoming ISO 200022 compliant and unlocking the value that would add opportunities enabled by the new standard. Audit committees should understand management's plans in order to be prepared for adoption. Regardless of the proposed deadline (November 2023), audit committees should request that management develop a thoughtful roadmap to implementation. The values offered by the new standard include not only regulatory compliance, but equally as important, domestic and cross-border interoperability, improved customer experience, cost reduction, operational efficiency, the ability to speed-up product rollouts, improved visibility into the status of payments, and richer and more-structured data. We suggest audit committees ask management for periodic updates on the strategy and development of the standards, including specific plans on how to achieve the desired benefits.

Goodwill accounting

Mergers and acquisitions always have been a big part of the banking industry, but it is especially so for the past decade or more, as the number of banks has dropped from 8,900 about 15 years ago to 5,200 today. Since 2001, all bank acquisitions have been accounted for using purchase accounting, which generally results in goodwill being booked to the acquirer's financial statements. This goodwill is subject to periodic impairment tests and, for some acquisitive banks, non-GAAP measures have been developed to better explain financial performance (e.g., return on tangible common equity). The Financial Accounting Standards Board is currently seeking comments on whether it should make changes to goodwill accounting, including potentially returning to an amortization approach in place of today's impairment tests. We suggest audit committees monitor the possible goodwill accounting change and understand how such a change might impact the bank's financial statements and regulatory capital.

About the KPMG Board Leadership Center

The KPMG Board Leadership Center champions outstanding governance to help drive long-term corporate value and enhance investor confidence. Through an array of programs and perspectives—including KPMG's Audit Committee Institute, the WomenCorporateDirectors Foundation, and more—the Center engages with directors and business leaders to help articulate their challenges and promote continuous improvement of public- and private-company governance. Drawing on insights from KPMG professionals and governance experts worldwide, the Center delivers practical thought leadership—on risk and strategy, talent and technology, globalization and compliance, financial reporting and audit quality, and more—all through a board lens. Learn more at kpmg.com/us/blc.

About the Audit Committee Institute

As part of the Board Leadership Center, KPMG's Audit Committee Institute focuses on oversight of financial reporting and audit quality and other issues of interest to audit committee members, including risk oversight, internal controls, and compliance. Learn more at kpmg.com/us/aci.

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