Navigating complexity and uncertainty

Insights from the 2023 KPMG Audit Committee Leadership Forum

Financial reporting issues are getting more complex. Demand for more and better disclosures keeps growing. Whether it's cybersecurity, ESG issues. or generative AI, audit committees are shouldering heavier and more complex risk agendas.

As audit committee members take stock of the macro issues impacting their agendas and consider how and where they are focusing their time and efforts, KPMG hosted audit committee members from leading companies at the 2023 Audit Committee Leadership Forum (June 13–14, in Carlsbad, California). Panel discussions provided insights into a host of challenges and emerging practices, including those highlighted below.

A global view on intelligence and information flow

As the risks that boards oversee continue to expand, information quality and flow become more important—and more challenging. Advances in AI are exacerbating that challenge with the risk of disinformation and misinformation undermining confidence and blurring fact and fiction.

Former presidential intelligence briefer Beth Sanner spoke with Scott Flynn, vice chair – Audit, KPMG LLP, about the risks and emerging threats in hot spots around the world, from the Russia-Ukraine war, tensions with China, and cybersecurity events to the energy transition and climate and water crises.

The discussion centered on the importance for boards and companies to focus on resilience and to prepare for and practice dealing with disruption. Noting that the underappreciated risks companies face "are many," directors may want to "start with the alligator closest to the boat," and then move on to issues not on the formal agenda, but that the board needs to start thinking about.

Beyond how boards use the information they receive, the discussion emphasized the importance of the fidelity of the information. "Pay close attention to where you're getting information." While the frequency of board discussions of geopolitics will vary by company, industry, and geography, among other factors, every corporate board "should be having a geopolitical conversation at least once a year," and probably more frequently.

Other takeaways from the discussion:

- On the US–China relationship: Companies should focus on de-risking in a way that's an opportunity or at least not a huge net negative. As US companies invest closer to home as a result of de-risking, "near-shoring is a win-win but you need to do the due diligence."
- On cyber: Assume you're a target. The company's CISO should know the local FBI cyber contact already.
- On discussing polarizing issues in the boardroom: Avoid using words that have political meaning and can distract from the main point. Why is the issue important to the company/business?
- Quality risk assessments and briefings require organization and discipline, and "the focus should be on how the threats relate to the business."

Navigating the regulatory wave ahead

The pipeline of new and proposed SEC rules is putting significant pressure on companies to update and modernize their internal controls and disclosure controls and help ensure that their finance and ESG functions are adequately staffed. Multinationals must also prepare for differing foreign ESG reporting regimes. Even in the absence of final SEC rules on issues such as climate and human capital management (HCM), investors, employees, and other stakeholders continue to demand more and better disclosure. Audit committees have an important role to play in helping their boards and companies navigate the changing regulatory landscape, panelists noted.

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Preparing for cybersecurity and climate rules

Audit committees are preparing for the the new SEC cybersecurity rules (adopted on July 26, after the event.) The rules require SEC registrants that are subject to the 1934 Act to disclose information about a material cybersecurity incident "within four business days after the registrant determines that it has experienced a material cybersecurity incident." Also see "SEC finalizes cybersecurity rules." Many large companies house board oversight for cyber risk in the audit committee, but even if cyber oversight is housed with the full board or another committee, the audit committee needs to oversee the effectiveness of internal and disclosure controls and procedures relating to cyber.

Speakers noted that the four-day deadline will be challenging for many companies, particularly in the midst of a crisis when they may not have all the facts.

Panelists noted the importance of management having a cyber response game plan that everyone on the board understands. Who is responsible? Do we have the right people? Who are the company's contacts in government? One speaker emphasized the value of "having a rapid response plan in writing. Document as much as possible." For example, what's the escalation process for a cyber event? What are the internal, external, and customer notification plans?

"Think about whether you need to enhance your risk factor disclosure on cyber to make clear that you experience cyber events."

Even as companies await a final SEC climate rule, the SEC continues to focus on climate-related disclosures through staff comment letters and enforcement actions. For example, "audit committees should be looking for consistency between what is in the SEC filings and what is posted on the company's website and elsewhere, as well the quality of the data."

One panel member shared the view that many sustainability reports could be problematic in the evolving disclosure environment because they are "far too anecdotal and granular," often aren't dated—and the disclosures may not have been vetted. "You need a date on the information because you are stating that it's accurate as of the date of the report. We need more top-down thought as to what is the company's ESG message? How do we prove it?"

As a result, sustainability reports may evolve going forward. "Whatever the final [SEC] rules, companies need to think about what they are saying in their sustainability reports and whether they can simply paste that information into their 10-K. You may not even have [sustainability reports] outside of SEC filingsh eventually."

Restatements and clawbacks

Audit committees should also prepare for the new clawback rules, which call for the recovery of erroneously awarded incentive-based compensation received by current or former executive officers in connection with a financial restatement. "Each time an accounting error issue surfaces, the audit committee is part of the decision-making as to whether to restate or do a revision."

The rules (being implemented through stock exchange listing standards, and effective October 1 with a December 1 compliance date) cover both so-called "big R" and "little r" restatements, and do not require misconduct or fault on the part of executives. While CEOs and CFOs who have long been subject to SOX certifications understand that their compensation can be at risk for clawback in the event of a restatement, other executives may not, panel members noted.

In the case of a restatement, there's an evaluation of whether ICFR were effective, which changes the narrative around ICFR. For example, what was the root cause of the error? How will the company remediate the deficiency in internal controls? Was the misstatement intentional for reasons of compensation? "Audit committees must re-evaluate their ICFR effectiveness conclusion and awareness of whether management benefited and if it was in a material way, and if so, why was that? Even if compensation is not impacted at all, there is also a disclosure question." Audit committee members should coordinate and discuss the decision around restating with members of the compensation committee.

When selecting financial metrics for executive incentive awards, one speaker urged boards to consider how prone the metrics are to misstatement. "If the metrics involve highly judgmental areas of accounting, you may be at greater risk of having to deal with a clawback."

Committee coordination with respect to clawbacks and other issues that touch multiple committees is critical and not always well defined. "Report-outs need to be clear so everyone understands the implications." Sharing materials among committees and inviting other committee members to committee meetings may be helpful. More broadly, panelists noted the importance of coordination among committee chairs, including to help ensure effective oversight of the company's mission-critical risks.

The audit committee + chief audit executive

Understanding a company's strategic and operational risks in an increasingly complex business environment is both a top priority and a top challenge today—and internal audit has a vital role to play. Staying attuned to the company's changing risk profile—including its control environment, culture, and crisis readiness—has put a premium on internal audit being in sync with the audit committee.

Panel members agreed that chief audit executives (CAEs) can help the audit committee understand what's happening at every level of the company (as the committee's eyes and ears), and connect critical dots.

Keys to boosting the CAE's value to the audit committee include:

- Understanding that the business landscape is changing and, therefore, having a "healthy concern" about a static internal control environment
- Setting an audit strategy that adapts to the changing operating environment, corporate strategy, and risk profile
- Being objective, structured, and disciplined (not adversarial)
- Making executive sessions (with the audit committee) structured and standard. "Out of pattern invites suspicion."

To be effective in their role, CAEs need full access to the audit chair and confidence that the board is helping to set the tone at the top. Indeed, the audit committee can help shape the role—and elevate the value—of the CAE from a compliance and controls function to a trusted advisor by setting clear expectations (and being realistic about internal audit's capabilities), championing the CAE's talent and resource needs, and ensuring the CAE "has an appropriate seat at the table."

The future of the audit committee

While the basics of audit committee oversight haven't changed (oversight of financial reporting and internal and external auditors), "other factors affecting boards are changing the work of the committee. Boards in general are busier than ever. New risks have emerged, and many of those typically end up on the audit committee's plate."

Amid the expansion of risk oversight, audit committees must balance what stays in the audit committee and what moves to the general board or to another committee based on where the board has the resources and skill sets. As panelists noted, the SEC-proposed climate rulemaking is "a complete game changer" that will impact risk disclosure, governance disclosure, controls, and processes. In determining how best to allocate oversight, the board should consider the key risks for the company, the skills on board, and which committees are best equipped to handle them.

On the disclosure front, "transparency is on everyone's minds. There's more [information] going into financial disclosures and more scrutiny. Audit committees are spending more time on the disclosure and the wording." As one speaker noted, "More boards are focusing on management's disclosure committee roles, or having another committee looking at other disclosure documents to make sure the messaging is consistent, and the metrics are aligned." "Any disclosure that will be included in SEC filings means the audit committee is involved," noted another.

One director noted that some of her audit committees have expanded the number of committee members. "The committee has gotten bigger so we can add new skills without depleting the audit committee's core focus on financial reporting."

Still, most boards are not bringing on single-subject experts to handle the emerging risks. "Experience in cyber is going to be more important as generative AI and cyber risk are getting more pronounced, but if you bring on a new director, there's an expectation that tech is not their only expertise. You need someone who understands the business and the risks, and who has functional expertise as well."

"Business is riskier. As the full board takes on more responsibility, roles are expanding and evolving. It's critical that audit committees evolve with the business and the operating environment." Directors also emphasized the importance of education to keep the committee's skills sharp. "Things are evolving so quickly, audit committee members have to stay educated on issues coming through."

One director noted that to help coordinate risk oversight, the board chair holds separate sessions with each committee chair. "More and more, I'm seeing coordination across committees, especially as some companies are breaking out certain risk to specialized risk or tech committees. There is overlap among committees, for example, between audit and comp, on proxy disclosures, and on the metrics used to judge pay for performance."

Forum speakers and moderators

Claudia Allen – Senior Advisor, KPMG Board Leadership Center

Joy Brown – Director, Tractor Supply, Huron

Anne Bramman – Director, McCormick & Co Former CFO, Nordstrom

Stephen Brown – Senior Advisor, KPMG Board Leadership Center

Stephen Dabney – Leader, KPMG Audit Committee Institute

Scott Flynn – Vice Chair, Audit KPMG LLP

Sonia Gupta Barros – Partner Sidley Austin

Tom Kim – Partner, Gibson Dunn & Crutcher

Cheryl Miller – Director, Celsius Holdings, Tyson Foods

Kelly Richmond Pope – Author, *Fool Me Once* Director, Greater Chicago Food Depository

John Rodi – Leader, KPMG Board Leadership Center

Beth Sanner – Former Presidential Intelligence Briefer and Former Deputy Director of National Intelligence

Mike Smith – Partner, Internal Audit & Enterprise Risk, Advisory, KPMG LLP

Mary Winston – Director, Acuity Brands, Chipotle, Northrop Grumman Corp, Toronto-Dominion Bank

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The KPMG Board Leadership Center (BLC) champions outstanding corporate governance to drive long-term value and enhance stakeholder confidence. Through an array of insights, perspectives, and programs, the BLC—which includes the KPMG Audit Committee Institute and close collaboration with other leading director organizations—promotes continuous education and improvement of public and private company governance. BLC engages with directors and business leaders on the critical issues driving board agendas—from strategy, risk, talent, and ESG to data governance, audit quality, proxy trends, and more. Learn more at kpmg.com/us/blc.

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As part of the KPMG Board Leadership Center, the ACI provides audit committee and board members with practical insights, resources, and peer exchange opportunities focused on strengthening oversight of financial reporting and audit quality, and the array of challenges facing boards and businesses today—from risk management and emerging technologies to strategy, talent, and global compliance. Learn more about ACI at kpmg.com/us/aci.

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