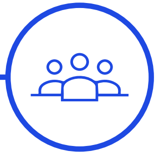
2024 Bank Audit Committee Agenda

KPMG Board Leadership Center

February 2024



A rapidly changing industry demands a more active bank board

Today's rapidly changing banking industry calls on bank boards to take a more active leadership role this year. Oversight of risk will be challenging with a preponderance of risks from industry-specific and geopolitical to new risks from the digital world, including cybersecurity, data privacy, and generative AI (GenAI). Bank regulators are also more active with changes and updates. Banks will need to be ready to respond to regulators with compliance, experience, and management.

With a myriad of risks and an uptick in regulatory activity, the board should emphasize financial reporting requirements and internal controls, ensure internal audit focuses on key risks, support management as the bank modernizes and potentially experiences talent flight, and counsel bank officers on ethics and culture. Given the scope of oversight required, 2024 should be a year the board delegates more tasks to its committees to increase the oversight of the reports and influence on bank management. To aid this endeavor, a series of questions accompanies each section of the 2024 Bank Board Agenda. Use the questions as thought starters and to guide discussions with bank leadership.

This year is filled with uncertainty about interest rates, the economy, geopolitics, and the US election. Reacting to each new crisis is not the best course of action and could put the bank at a disadvantage. The board needs to be attentive, proactive, and forward thinking in 2024.

As financial reporting becomes more complex with influence from current operating environment, cyber, climate, tech, and AI, bank boards should redouble their focus to help ensure that management's internal controls, disclosure controls, and procedures are keeping pace.

Peter Torrente
US Sector Leader,
Banking & Capital Markets, KPMG

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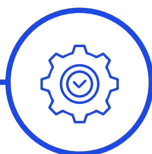

Focus on financial reporting and internal controls

In any year, it is prudent for boards to prioritize attention on financial reporting requirements and internal controls for risk management. In 2024, it is imperative. Oversight of risk will be daunting given the breadth of risks that banks face, including industry-specific, regulatory, geopolitical, climate change, cybersecurity, data privacy, generative AI, as well as risks encountered with digital technologies relied on for bank digital transformation initiatives.

For audit committees, a comprehensive risk assessment is mandatory given its role in the planning phase of an audit. The assessment is the level playing field for identifying, mitigating, and disclosing material risks. Boards should have the risk assessment under their purview, along with an eye on two standout risk concerns. One is risk concentration that occurs when the bank has a high concentration of assets, liabilities, or activities in a particular area or sector. Risk concentration puts added risk on the bank that the board should be aware of. The other risk is from social media. Negative comments, reviews, or posts can go viral and damage a bank's reputation and lead to, as it did, to swift deposit outflows.

Boards should verify the accuracy of the Statement of Cash Flows (SCF) and look beyond the balance sheet and income statement in assessing the bank's soundness. The Financial Accounting Standards Board (FASB) added a project to its agenda whereby it is exploring reorganizing and disaggregating the statement of cash flows for financial institutions and developing a disclosure about an entity's cash interest received to improve the decision usefulness of the statement. Throughout the year, monitor updates on the FASB's statement of cash flows project for changes and priorities.

Boards should seek answers to the following 10 questions that are designed to increase the focus on financial reporting and internal controls:

- Which executives are responsible for identifying material financial, liquidity, concentration, credit, and operating risks?
- How is management identifying and mitigating identified risks?
- Does management have an incident response plan that can be used for a wide range of incidents or crises? Have the plans been tested?
- Is concentration risk being monitored via metrics and addressed through dispositions or redirection of investments?
- Are sufficient and experienced special asset management resources in place to proactively work through potential problem loans?
- Are processes in place to monitor social media for shifts in sentiment or other negative news that could impact bank customer behavior?
- Are processes in place to monitor digital channels for unusual or higher-volume activities and have call center staff and artificial intelligence (AI) tools been trained to identify and report such activity?
- Are transparent disclosures of such risks and mitigation activities included in the company's SEC filings?
- What processes and controls are in place to assess the statement of cash flows conformity with US GAAP requirements?
- Has management identified any classification errors in the current year-to-date or prior year statement of cash flow? If yes, how has management assessed whether correction in the current period as a little "r" restatement is appropriate verses a big "r" restatement?

Bank boards should prioritize financial reporting requirements and internal controls given the myriad of risks. Boards should emphasize accurate reporting, strong internal controls, and effective risk management. Delegating tasks to committees can amplify the board's oversight and strengthen its influence on management as the bank navigates increasing complexities."

Diana Kunz
Audit Sector Leader –
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Reinforce audit quality and compliance oversight

Banks are subject to a myriad of regulations and laws that result in audits and compliance. However, the Public Company Accounting Oversight Board (PCAOB) has proposed changes to auditing standards that would heighten the auditor's responsibilities for detecting instances of noncompliance with laws and regulations. These proposed changes are dependent on SEC approval.

For boards that have the responsibility to ensure the bank complies with all applicable laws and regulations, the board should reinforce audit quality and stress compliance oversight. The added regulatory burden could have consequences. Failure to comply could have either a direct or indirect material effect on the financial statements. Auditors would be required to determine a complete population of laws and regulations that apply to the bank, including across jurisdictions, to identify all instances of noncompliance. The PCAOB's economic analysis of the proposed changes to the standard acknowledge that new requirements would result in additional, potentially substantial costs to auditors and the companies they audit. Increased costs may arise due to the need to supplement the audit engagement team with additional resources knowledgeable about banking laws and regulations.

The Auditor's Use of Confirmation, a PCAOB standard effective for fiscal years ending on or after June 15, 2025, warrant the board's attention, ensuring risk management objectives are met when auditors are required to send confirmations to bank customers regarding their accounts.

Bank audit and risk committees, with the board's oversight, should seek answers from management regarding these questions:

- What is the status of the PCAOB's proposed NOCLAR rule and the expected impacts of the final standard on the bank's internal processes and the audit?
- Who is responsible for compiling and maintaining a complete list of relevant laws and regulations across the bank, including across jurisdictions?
- What controls are in place over the completeness and accuracy of the list of relevant laws and regulations?
- How does management assess whether potential noncompliance has either a direct or indirect material effect on the financial statements, internal controls over financial reporting, and who is responsible for reviewing such conclusions?
- Who is responsible for coordinating, reviewing, and signing confirmations sent by the external auditor to bank customers to ensure that risks to data privacy or breach are minimized?

Priority Spotlight

The staff of the Public Company Accounting Oversight Board issued a spotlight on its 2024 priorities.

- Additional scrutiny of regional public banks
- Ongoing changes in interest rates, which can have a material effect on a company's liquidity
- Allowance for loan and lease losses
- Classification of investments as available for-sale or held-to-maturity
- Valuation of investments in hard-to-value securities
- Ability to meet margin requirements
- Ability to meet long-term debt obligations
- An entity's ability to continue as a going concern

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Clarify climate/sustainability disclosure requirements

Understanding the risks brought by the energy transition, more frequent and destructive severe weather events, and a changing regulatory landscape is crucial for businesses to preserve and enhance their financial value. Investors are keen to have reliable and transparent information to support their conclusions. Therefore, Bank regulators continue to push forward issuing final principles for climate related financial risk for large financial institutions with over $100 billion in assets. The regulators expect these banks to implement processes for assessing, identifying, and managing emerging and material climate-related risks with effective board oversight. Climate risk information should be integrated with internal reporting, monitoring and escalation processes, as well as effective risk data aggregation and external and regulatory reporting capabilities. Regulators assess the accuracy and alignment of a firm's reporting with its public statements, commitments, strategy, and products/services marketing.

Accuracy and alignment hinge on collecting high-quality climate/sustainability data, which is crucial for required disclosures. Data quality is defined as such if it meets the criteria of accuracy, reliability, and consistency. The board or audit committee should be informed and attest to data quality. Poor data quality can result in non-compliance and legal risks to the bank. The same reported data is used by investors, stakeholders, and other interested parties to make informed decisions about a company's sustainability practices and performance. Ensuring high-quality climate/sustainability data is essential for companies to effectively communicate their sustainability efforts and maintain stakeholder trust.

The board's insistence on data quality will also be instrumental (if applicable) with California's new environmental disclosure laws. The California climate legislation includes disclosure of Scope 3 emissions, which can be challenging for banks to estimate.

- How is the bank currently addressing the final principles for climate-related financial risk for large financial institutions with over $100 billion in assets?
- What processes has the bank implemented for assessing, identifying, and managing emerging and material climate-related risks with effective board oversight?
- How is the bank integrating climate risk information with internal reporting, monitoring, and escalation processes, as well as external and regulatory reporting capabilities?
- What measures has the bank taken to ensure the accuracy and alignment of its reporting with its public statements, commitments, strategy, and products/services marketing?
- How is the bank collecting high-quality climate/sustainability data, and what criteria does it use to define data quality?
- What steps has the bank taken to ensure compliance with California's new environmental disclosure laws, particularly with regard to estimating Scope 3 emissions?

Accuracy and alignment are crucial for required disclosures and hinges on collecting high-quality climate/ sustainability data.

[1] The Latest Dirty Word in Corporate America: ESG - WSJ

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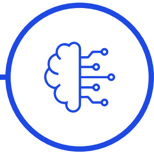

Step up oversight responsibilities of generative AI

The board is well aware of the digital transformation underway at the bank, from consumer-facing mobile applications to integrating instant payments. Digital transformation has been a multi-year initiative often referred to as bank modernization. Now there is an emerging technology making a name for itself in financial circles—generative AI (GenAI). A 2023 fourth quarter KPMG survey found that financial executives are accelerating AI adoption with GenAI being a top priority. Among survey findings, 52 percent of financial executives said their companies are already piloting or deploying GenAI, while 37 percent are in the research and planning phase.[2] GenAI promises amazing improvements in areas that support finance, including financial analysis, compliance, scenario risk management, and internal audit.

Despite GenAI's promising future, the board should be fully aware of the risks when using this emerging technology like data privacy and hallucinations or biases that occur with GenAI output. For the board, the emphasis should be on corporate governance, internal controls, and auditing to ensure that the technology is used responsibly. Executives within the bank may get caught up in the hype of GenAI and push for adoption and use cases. It's up to the board and the strength of its committees to exercise caution and ensure appropriate governance and accountability. Rest assured, regulation will be a fast follow. Banking regulators will likely apply existing regulations to GenAI across its lifecycle and ascertain whether the technology can be trusted, work as claimed, and causes no harm.

The board, along with audit and risk committees, should understand how management is progressing with GenAI on a regular basis. Explore these questions:

- Are our data and systems ready for the implementation of AI/GenAI solutions?
- Have we developed clear guidance and policies around ethics, trust, and proper use of AI to ensure the impact on customers, employees, and other stakeholders is taken into consideration?
- Have we considered partnerships with fintechs or other third parties in the development of AI/GenAI solutions?
- Are we prepared to hire data scientists, machine learning engineers, domain experts, and provide training for existing employees to ensure the workforce is ready for GenAI implementation?
- Have we considered using pilots or trial periods to test generative AI under controlled conditions?
- Have we established performance metrics to evaluate the impact AI solutions are having on efficiency, cost avoidance, innovation, and growth?

Regulators have been very clear that existing regulations apply to the span of "automated systems" – including AI and GenAI.

[2] "AI and Financial Reporting Survey – what are companies doing and where do you stand?," KPMG LLP. October 2023

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Ensure internal audit focuses on key risks

Bank regulators often look to internal audit to assess remedial actions taken by banks to address regulatory examination findings determined to be matters requiring attention (MRA) and matters requiring immediate attention (MRIA). Therefore, for internal audit to be a valued resource to the board's audit committee, they need to go beyond financial reporting and compliance tasks and direct their attention on the company's key risks—the fertile ground for root cause analyses and remedial actions.

In some instances, the criticisms highlighted by bank regulators in the MRAs/MRIAs are directed at the bank's board or committees of the board. The board is suddenly in the spotlight. As such, it is critical for the board to have internal audit tapped to evaluate and obtain a thorough understanding of the root cause of MRAs/MRIAs. The investigation into the root cause analysis could go in a unique way. Findings could suggest weaknesses in tone at the top or a lack of governance, which might also impact entity-level controls, as well as reporting on internal controls over financial reporting. It is why internal audit needs to focus on bank risks. Investigations into MRAs/MRIAs could impact different areas of the bank. Internal audit is capable in assessing remedial actions that would satisfy bank regulators.

Ultimately, it is management and the board that bears responsibility for ensuring remediation steps are implemented and address regulatory findings. The board's audit committee needs to be in lockstep with internal audit and, if necessary, engage independent auditors to understand the impact of the MRAs/MRIAs on the external audit. Explore these questions:

- How can internal audit expand its area of responsibilities to include a focus on key risks?
- What is the role of internal audit in evaluating the root cause of MRAs/MRIAs?
- How can internal audit assess remedial actions that would satisfy bank regulators?
- What is the internal process for ensuring remediation steps are implemented that address regulatory findings?
- How can the board's audit committee improve in how it works with internal audit to address MRAs/MRIAs?
- What is the impact of the MRAs/MRIAs on the external audit?

The board and bank management are responsible for ensuring remediation steps are implemented and address regulatory findings.

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Target fallout from leadership/talent vacuum

As banks look to optimize costs structures while also modernizing bank operations, there could be a loss of leadership and talent. Optimizing cost structures can lead to a reduction in workforce or executives taking advantage of early retirement programs. The board in its capacity of overseeing bank management, should probe the management team about potential impacts to the control environment. The departure of long-tenured employees can call into question whether policies, processes, and controls are well documented. The loss of an executive can leave a department rudderless.

In periods of change, the potential impact to the control environment requires evaluation by management. For example, the accelerated utilization of data, analytics, and AI demands a new set of controls. And if employee tasks are replaced by automation as many predict with AI/GenAI, monitoring controls need to be added to ensure automated tasks perform as advertised. AI/GenAI may also require using a third-party like a fintech or specific skillsets like data scientists that demands new policies, processes, and controls. The same is true with climate and sustainability reporting requirements. It is new for the bank and requires governance and accountability. For the board, responsible for ensuring the bank is operating in a safe and sound manner, the leadership/talent vacuum intersecting with digital transformation is challenging but also board confirming. It is a transforming time for the bank, and the board's views and being a sounding board for management is needed now more than ever.

As bank management experiences a fallout from leaders and employees departing, here are questions to ask of management:

- Are the policies, processes and controls well documented in areas where key positions are vacated by long-tenured employees such that a smooth transition of such responsibilities can occur?
- Where employee tasks are replaced by automation, what monitoring controls are in place to ensure that such tasks continue to occur as intended?
- How is the bank preparing for the implementation of new controls required by the accelerated utilization of data, analytics, and AI?
- How is the bank addressing the need for new policies, processes, and controls related to climate and other sustainability reporting requirements?

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Sharpen bank's focus on ethics, compliance, and culture

Bank regulators are giving heightened attention to ethics, compliance, and culture. Regulators are looking to banks to conduct risk and ethical business practices and view conduct risk as connected to risk culture and to the integrity and reliability of reporting, marketing/advertising, and customer interactions. Regulators also expect management to develop a culture of compliance and "individual accountability," including incentives for ethical behavior and culture commitment, disincentives for misconduct, and business practices that place the interests of customers first.

The board should pay attention to regulator moves. Issues related to tone at the top and governance while not having a direct impact on the financial statements may indicate weaknesses in entity level controls and reporting on internal controls over financial reporting that require evaluation by management and the audit committee. For public entities, the SEC's new clawback rule requires a recovery analysis be performed for either a big "R" or little "r" restatement to correct an error to previously issued financial statements to determine whether incentive-based compensation needs to be recovered from executive officers. For bank management and the board, what is important is knowing that regulators may emphasize ethics, compliance, and culture. When that occurs, having policies in place and documentation can go a long way to satisfying regulators.

For the board, the audit committee's oversight of culture extends to the external audit firm. The SEC and PCAOB recently emphasized the importance of an audit firm's culture, indicating that the auditor's gate keeper function is rooted in its integrity and culture and is the foundation of high-quality audits. A firm with a strong culture is key to exercising the proper professional skepticism. Boards' audit committees should inquire of the independent auditor to understand the training on ethics and integrity provided to its professionals; also ascertain how the firm promotes a raise your hand culture and measures taken to hold professionals accountable for their conduct.

The board's role is counseling bank management on ethics and culture, like leading the charge on ethics training and recommending a program for creating a speak-up culture that can help stop wrongdoing. These questions can help drive discussions and actions.

- How is the bank currently addressing the heightened attention from regulators on ethics, compliance, and culture?
- What specific measures is management taking to ensure that the bank conducts risk and ethical business practices?
- How is the bank incentivizing ethical behavior and culture commitment, and what measures are in place to disincentivize misconduct?
- What policies and documentation does the bank have in place to satisfy regulators' emphasis on ethics, compliance, and culture?
- How is the bank addressing tone at the top and governance issues, and what measures are in place to evaluate entity level controls and reporting on internal controls over financial reporting?
- What steps is management taking to create a speak-up culture that can help stop wrongdoing, and how can the board support these efforts?

A KPMG CEO Survey found that 84 percent of CEOs say their organization's business success, including growth objectives, depends on their company having a strong ethical culture.

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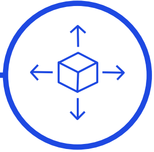

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