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Audit Committee Leadership Network

ACLN VIEWPOINTS

Audit committees in a dynamic era of risk

December 2023

With today’s companies facing a widening array of complex, interrelated risks, risk oversight is increasingly one of the audit committee’s most critical responsibilities. Audit chairs should remain vigilant that risk oversight keeps pace with a dynamic risk environment and the needs of their companies.

In fall 2023, Tapestry Networks held conversations with members of the North American Audit Committee Leadership Network (ACLN) and the European Audit Committee Leadership Network (EACLN) to explore this topic. Members discussed their companies’ most pressing risks and good risk oversight practices for boards and audit committees.

For a list of participating audit chairs, please see Appendix 1 (page 12). For a list of reflection questions for audit committees, see Appendix 2 (page 13).

This *ViewPoints*[1] covers key themes that emerged in the discussions:

Risks continue to expand in complexity and interconnectedness

Risk oversight is more crucial than ever

Audit chairs must tightly manage growing committee agendas

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Risks continue to expand in complexity and interconnectedness

Audit committees face risks that are growing in scope, complexity, and intensity. The 2023 EY Global Board Risk Survey notes that "boards face sharper challenges in navigating a risk environment that has become more expansive, complex, and interconnected."[2]

In addition to their core audit committee oversight responsibilities for financial reporting, compliance, and internal controls, members identified top risk concerns:

- **Artificial intelligence (AI) and other technology-driven risks.** The recent and rapid development and adoption of AI has catapulted it to the top of many companies' risk registers. *"From an audit chair perspective, I'm thinking about it from a control framework standpoint. What are the risks? What are the company's policies to deal with the risks and a framework to control those risks? Are the policies in place? The rest of it—what the opportunity is, how to make money on it, what to invest in—that is a full board discussion,"* a member said. Members described AI-related risks including ethics, reputation, competitiveness, disinformation, misinformation, and fraud. Inadequate employee training around the risks of working with AI is another concern; for example, employees may not be aware of the issues associated with AI and rely too heavily on results from AI tools, which could impede improving the overall quality of the work performed or the outputs produced.
- **Cybersecurity.** *"Some aspect of cyber is discussed at every single audit committee meeting,"* an audit chair said. Even when the full board or a specific committee is charged with oversight of cyber risk, the audit committee will inevitably have some involvement with cyber issues because of the potential for severe financial impact. And many audit committees retain full responsibility for cyber oversight. Members highlighted the rapid evolution of cyber risks and the increasingly sophisticated nature of attacks. Cybersecurity remains a top-of-mind issue for audit chairs, and some ACLN members noted that the reporting requirements in the US Securities and Exchange Commission's (SEC) new cybersecurity risk management, strategy, governance, and incident disclosure rules,[3] and the heightened transparency around the oversight of cybersecurity risk management, will require further consideration to link disclosure to the company's strategy and overall risk management.
- **Political and regulatory uncertainty.** With several major countries slated to hold elections in 2024,[4] broad changes in public policy and in regulatory agendas are likely to continue. *"The unpredictability of Washington is frightening,"* one ACLN member said. The environmental, social, and governance (ESG) regulatory

landscape is a prime example of policy uncertainty and volatility. ACLN and EACLN companies face rapidly developing and complicated reporting requirements, including the EU's Corporate Sustainability Reporting Directive, the SEC's proposed climate-related disclosure rules, and the recent California climate disclosure regulations. Ensuring compliance across the multitude of disclosure rules will prove challenging, especially where different mandatory disclosures do not align. Audit chairs anticipate that litigation against ESG regulations will add further complication to reporting challenges in future years. What is more, EACLN members noted that companies are subject to increasing scrutiny from nongovernmental and media stakeholders around ESG-related matters.

- **Shifts in global tax policy.** The inconsistent adoption of tax rules proposed by the Organisation for Economic Co-operation and Development's Base Erosion and Profit Shifting project is of concern to EACLN audit chairs. These rules may result in conflicts with global efforts to incentivize the green transition, making it difficult for European companies to compete on a playing field that seems to be skewed in favor of US firms. An EACLN member noted, *"I think tax is an area that's a big upcoming risk because of governments needing additional funding. There are new kinds of taxes: green tax, lifestyle taxes, and different profits taxes, such as the banking sector experienced. It seems to me that those kinds of regulations cause high levels of risk and can have a huge impact."*
- **Tensions stemming from international conflict.** *"Geopolitical tensions are a real concern for companies,"* an audit chair emphasized. ACLN and EACLN members have previously described significant geopolitical risks that their companies face amid ongoing global tensions, which vary depending on the company, its geographic locations, and its industry. Some companies, for example, are weighing whether to continue business operations in China. Geopolitical instability and disruptions will likely escalate in the years ahead, and members expect it to remain a top risk for their companies.
- **Labor challenges.** Boards are paying more attention to risks associated with labor after a year of worker unrest. In the US, strikes or strike threats occurred in a range of industries. European companies also saw considerable organized labor activity this year. *"Labor issues are not typically a board-level discussion, but the environment is changing, even just in the last six months,"* a member said. He explained, *"While it is not a direct audit committee responsibility, it is a risk for the company, and I want to bring it up with the compensation committee and lead director. I want to understand: How are we preparing, given the strikes happening this year? How do we get ready for a potential strike next year when a major contract is expiring? What is our relationship with the union? Who from the board is more deeply involved in ensuring there are good processes and governance around getting ready for that?"*

- **Unforeseen or "black swan" risks.** The *"grand challenge"* of risk assessments is to *"think outside the box,"* a member said. Several emphasized ongoing concerns about risks that arise that are not yet on a company's risk cartography, especially ones that could have significant impact. *"Those are the types of things that hit you hardest, but they also do not fit nicely in a matrix,"* one member said. Another felt that his company could be more effective at risk foresight: *"By the time we find out about a risk, it's no longer a risk because the damage has already occurred."*

Risk oversight is more crucial than ever

Risk oversight responsibilities beyond traditional audit and control topics are increasingly falling to audit committees. While full boards necessarily retain responsibility for overall risk oversight, large portions of that responsibility are often delegated to audit committees, usually including oversight of the enterprise risk management (ERM) program. Yet, while *"the audit committee often owns risk oversight, that doesn't mean we own all risk,"* one audit chair said. Others agreed, noting that certain risks should be delegated to other board committees or retained at the full board. One suggested asking, *"Is this really a risk the audit committee can oversee, or is it one the full board should be thinking about with the benefit of everyone's perspectives on the issue?"*

Members described good practices for how their boards and audit committees approach risk oversight:

- **Explicitly assign oversight responsibilities for each risk.** Many audit chairs use a risk-allocation matrix, created as part of the ERM program, to map a company's top risks and assign oversight at the board level. Some committees may be better suited to address certain risks; for example, if a board has a separate technology committee, cybersecurity risks may be best addressed there. *"Risk registers are an important part of our oversight approach. When you lay it out on a piece of paper, do the key risks of the company map to someplace among those committee charters and roll up to the board in some way?"* a member said. There should be no confusion over who is ultimately responsible for which risks and where they are overseen at the board level, members stressed. Reporting back is also important; one member said, *"Once a year, each of the other committees reports to the audit committee about what risks they manage and how they manage them."*

Should a board establish new committees or subcommittees to address new or evolving risks?

Some boards create a new committee or subcommittee when a significant new risk requires attention. But one member recommended this approach only when truly necessary: *"The first step is to figure out where things could easily be covered by an existing committee. The next line of defense would be to create a new committee."* Subcommittees should be the *"third line of defense."* The member acknowledged that subcommittees can be particularly useful in the face of emerging, short-term problems: *"Subcommittees should not stand forever. If they do, you should just make it another committee. They can be valuable for something happening at a particular time or something new that needs to be worked out with specific expertise. You can let the subcommittee work it out, then bring it to the full committee, then to the board."*

- **Ensure frequent and effective coordination between committees.** Strong coordination between committees assigned with aspects of risk oversight is essential to promote knowledge sharing and ensure that all key risks are addressed. Members described several practices to support coordination:
  - **Establish formal and informal communication channels between committee chairs.** *"We interact at the committee chair level a lot. We make sure nothing is falling through the cracks,"* a member said. Another gave an example: *"With ESG, we spent time figuring out roles and responsibilities for the two committees involved. We mapped it out, ensured everything was covered, and identified areas of overlap to work through. The discussion around those overlapping areas was typically the committee chairs getting together and agreeing how to handle it."* Some audit chairs attend other committee meetings, even when they are not a member, to hear relevant issues firsthand.
  - **Assign overlapping committee members.** Having members serve on multiple committees enhances the flow of information. In one company, all committee chairs sit on the compensation committee, *"since all roads and risks essentially lead to compensation."*
  - **Hold joint meetings.** Members reported holding joint meetings for committees that oversee overlapping risk elements. Some hold these meetings annually; others do so more frequently.
  - **Leverage the corporate secretary and management for insights.** *"A big partner to me is the corporate secretary, who is mindful of areas that I should know about as the audit chair,"* a member said. *"They may say, 'This is a*

subject that you could really benefit from hearing directly as opposed to just reading,' and help coordinate the schedule to make sure those committees don't meet at the same time." Members of management, such as the chief financial officer, can also be *"on the lookout"* for matters that may have implications for the audit committee.

- **Incorporate active horizon scanning and response planning for emerging risks.** Detecting risks not yet on anyone's radar is naturally a challenging task. Nevertheless, members discussed the importance of having a process in place to unearth, assess, and respond to emerging risks. Members described approaches:
  - **Establish a process for input on emerging risks.** One member explained her approach: *"I ask, 'What is our 'BP Deepwater Horizon oil spill' type of risk that no one is thinking about? What risks do we not see coming that could cause both financial and reputational harm? We are including that and several other provocative questions in a questionnaire to ask for thoughts about unknown risks."* Another described a cross-functional, executive-level risk committee that meets quarterly and begins each meeting by discussing emerging risks. *"They do it on the front end, so it doesn't get squeezed out. The beauty of that cross-functional group is that they look at the white space between functions, which is where a lot of risks lie,"* he said.
  - **Focus on crisis preparedness and scenario planning.** Recent years have reinforced the need for companies to recognize the possibility of major unforeseen events, but members cautioned against spending too much time trying to identify unpredictable black-swan risks. *"You just have to be able to be nimble and respond in a crisis. You can't spend your time identifying the black swan,"* one said. Instead, efforts should focus on strengthening crisis preparedness and conducting scenario planning. *"The critical part is to have cross-functional coordination and quick response during a crisis. If you have those capabilities, you will respond better than others. You cannot plan for all the details of black-swan events because you don't know how they will actually happen, but you can plan for the organization's capability to respond to a crisis."*

How much time should audit committees allocate to unknown risks?

One member offered advice*: "You are not trying to forecast everything. Think of it more in terms of the many realities that could happen, then create an envelope of those possibilities. You have to accept that you will miss things on either side of the envelope, but also accept there's a lot of resource that can get burned trying to deal with things outside of it. The question I ask is, What would a reasonable person on a jury have expected you to do? That's the envelope you want to worry about."* She described one company that invited a futurist to speak with the board and management about trends and issues that could come to fruition*. "To me, that is knowable and should be included in the envelope."* Audit committees should not spend too much time on *"unknowable"* risks, she said, adding, *"If you spend money on that, you're burning shareholder resources, and that is not a good thing."*

- **Embed risk awareness into organizational culture.** People at all levels in an organization can help surface risks when the culture encourages them to do so. Audit chairs should be attentive to how organizational culture either constrains or enables employees to contribute to companywide risk awareness. Citing AI as an example, one member described how top executives are often unaware of how AI technologies are used in their companies—*"but someone in the organization does know what's going on and can identify what the risks are."* Audit chairs should *"make sure the culture identifies risk awareness and that there is a way for risks to be surfaced, analyzed, and prioritized. You need a culture that does not suppress risks but celebrates that they have been identified."*

- **Consider whether mitigation practices need strengthening.** Some members noted a new focus on risk mitigation, not just identification. *"We talk about risk identification a lot but not much about mitigation. Our mitigation activities are much weaker than the planned activities to identify risks,"* one said. Another shared a similar observation: *"A lot of companies are better at identifying risks than focusing on the mitigation actions that can be taken so that part of the risk goes away, and it then becomes residual risk."* Audit committees should understand the processes that cause changes in risk prioritization. As one member noted, *"There's a lot of judgement involved in that process. What are the underlying actions or assumptions that move a risk from a rating of eight to a new rating of four?"*

Should boards consider a risk committee?

Given the expanding responsibilities of audit committees and the increasingly complex risk environment, some boards may consider forming a separate risk committee. Except for large financial institutions, risk committees are not mandatory for public companies. Members debated whether to exercise the option of creating a risk committee; their views varied.

Several members with experience of separate board risk committees said that they should be considered only when circumstances truly necessitate it. They cited challenges with overlap. *"Issues of risk and audit are inextricably linked,"* one said. Another advised, *"You want to be very thoughtful about forming a risk committee and think about what the scope of the committee would be, so it is not overly duplicative with the audit committee and avoids overlap with the full board. It's tricky. I have some caution about creating one in a nonfinancial institution. I could see it in a company with a complex, global manufacturing and supply-chain environment where the risk committee could be very focused."* One member stated, *"We have enough committees and, practically, the information needs are covered by one or the other. Why should audit and risk be separated?"*

Other members were more supportive of establishing a separate risk committee and pointed out the benefits it can provide. One noted that risk discussions require a different mindset from traditional audit matters, explaining, *"There's a fundamental difference between the audit committee, which is there to oversee the reporting on what has happened, versus the risk committee, which is looking forward and scenario planning. This helps each committee focus on its primary responsibility and helps the relevant committee members make informed decisions. The thinking, analysis, and precision of information is different in the two committees."* Risk committees also ensure that a board committee devotes sufficient time to address the complexity of the risk environment, emerging risks, and oversight of risk management processes.

One member described a situation where a separate risk committee was effective. The board had previously set up several time-limited, ad-hoc committees to address significant new risks. However, as the member explained, *"The audit committee realized these issues were too big to deal with as part of our normal course, and that there were possibilities for more of those types of risks in our business. We agreed to set up a risk committee separate from the audit committee. We determined the charter of the committee, how it would overlap with the audit committee, and agreed that, at a minimum, the audit chair and risk committee chair would participate in both committees. To further ensure commonality, we have two other risk committee members on the audit committee and an annual joint meeting."*

Audit chairs must tightly manage growing committee agendas

Ballooning audit committee agendas are a well-known challenge for audit committees who face responsibility for nonfinancial risks like cybersecurity and ESG. A member said, *"There is a silent understanding that new risks go to the audit committee."* But some asserted that a growing workload could be manageable if approached in the right way. *"I think everyone is cognizant that audit committee meetings tend to be lengthier. The agenda is always full, but if it is premanaged or if there is a plan laid out for the year, there is an understanding that appropriate topics get the appropriate level of attention,"* one said.

All audit chairs face a fundamental tension: new risks need to be covered, but continually adding novel responsibilities to audit committees can reduce time spent on fundamental audit topics. One chair explained, *"Something like AI or ESG could consume a whole meeting. All of a sudden, the routine matters from audits, adjustments, financial reporting, and disclosures take the back seat. That is the greater risk. Are we spending inadequate time on the core blocking and tackling that audit committees should do?"*

Making the most of meeting time is therefore crucial. Good practices include the following:

- **Firmly managing audit committee agendas to allow time for risk conversations.** Audit chairs must focus the committee on key issues, including risk discussions. *"Members can get sidetracked into business performance discussions. If that happens, I will reorient them and note that we can pick it up in the full board,"* a member said. Another recommended holding executive sessions at the start of committee meetings, which can enable the chair to communicate priorities and save time during the meeting. Members reported holding *"meetings before the meeting,"* often with the chief financial officer or chief audit executive, to plan agenda timing and identify topics of greater complexity. One member recommended meeting with the chief risk officer: *"I have a one-on-one with the person leading the risk assessment process several times a year to get their input in an executive-type session. I find that to be effective."*
- **Limit time covering prereading materials.** One member changed how management presented prereading to focus discussion time on important topics: *"We started being far more disciplined in having management not present information that was already in the preread. Instead, we say that it should be taken as read and we ask management about areas of concern. It was really hard to do, but worth the effort and easily frees up 30–45 minutes of time in our meetings."*
- **Use special meetings.** Deep dives and education sessions can be useful when

audit committees want a fuller understanding of specific risks. A member explained, *"It often feels like we do not have enough time to delve into certain topics in our committee meetings, so we take those topics out of the audit committee meeting so we can delve into them further and spend enough time on them."*

Even with strong committee leadership, concerns around limited time and expanding agendas persist for some audit chairs. One worried about the potential for committee members to defer too much to the chair. Audit chairs prepare extensively for each committee meeting, often holding numerous conversations with members of management, other committee chairs, and others that provide important insight to inform decisions. *"I'm doing so much offline and outside of meetings that I worry at times that as much as I try to bring committee members in, I'm sensing a real willingness to defer to the audit chair. For example, I may be comfortable on a certain topic because I've spent two hours discussing it with management and others beforehand, but I'm not sure how the rest of the committee could be comfortable with it. I worry that I'm a one-man band to some extent,"* the member said.

Is overconfidence bias a concern for audit committees?

Audit chairs may need to consider the danger of overconfidence bias, which can cause even top experts to overestimate their abilities to make accurate assessments of risk. One member said, *"I try to be confident that I've done all I can do, but humble enough to ask, Is it enough? I try to strike a balance between confidence and humility."* Recruiting the right people to serve on the audit committee is crucial to counter overconfidence and other cognitive biases. Members stressed the importance of having committee members with diverse backgrounds—not just financial—and giving every committee member a voice. This can encourage fresh perspectives and new questions. Members also encourage a learning mindset and get external input to *"make sure you don't just have an inside-out view."*

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About this document

The Audit Committee Leadership Network is a group of audit committee chairs drawn from leading North American companies committed to improving the performance of audit committees and enhancing trust in financial markets. The network is organized and led by Tapestry Networks with the support of EY as part of its continuing commitment to board effectiveness and good governance.

ViewPoints is produced by Tapestry Networks to stimulate timely, substantive board discussions about the choices confronting audit committee members, management, and their advisers as they endeavor to fulfill their respective responsibilities to the investing public. The ultimate value of *ViewPoints* lies in its power to help all constituencies develop their own informed points of view on these important issues. Those who receive *ViewPoints* are encouraged to share it with others in their own networks. The more board members, members of management, and advisers who become systematically engaged in this dialogue, the more value will be created for all.

Appendix 1: Participants

The following ACLN members participated in all or part of the ACLN meeting:

Fernando Aguirre, Audit Committee Chair, CVS Health
Joan Amble, Booz Allen Hamilton
Jeff Campbell, Audit Committee Chair, Aon
Ted Craver, Audit Committee Chair, Wells Fargo
Bill Easter, Audit Committee Chair, Delta Air Lines
Lynn Elsenhans, Audit Committee Chair, Saudi Aramco
Tom Freyman, Audit Committee Chair, AbbVie
Bella Goren, Audit Committee Chair, General Electric and Marriott International
Gretchen Haggerty, Audit Committee Chair, Johnson Controls
David Herzog, Audit Committee Chair, MetLife
Akhil Johri, Audit Committee Chair, Boeing and Cardinal Health
Paula Price, Audit Committee Chair, Accenture and Warner Bros. Discovery
Tom Schoewe, Audit Committee Chair, General Motors and Northrop Grumman
Cindy Taylor, Audit Committee Chair, AT&T
John Veihmeyer, Audit Committee Chair, Ford

The following EACLN members participated in all or part of the EACLN meeting:

Eric Elzvik, Audit Committee Chair, Ericsson and Volvo
Renato Fassbind, Audit Committee Chair, Nestlé
Margarete Haase, Audit Committee Chair, ING
Marion Helmes, Audit Committee Chair, Heineken
Dagmar Kollmann, Audit Committee Chair, Deutsche Telekom
Benoît Maes, Audit Committee Chair, Bouygues
John Maltby, Audit Committee Chair, Nordea
Maria van der Hoeven, Audit Committee Chair, TotalEnergies

EY was represented by the following in all or part of the meetings:

Julie Boland, US Chair and Managing Partner and Americas Area Managing Partner, EY
Dante D'Egidio, Americas Vice Chair – Assurance, EY
Marie-Laure Delarue, Global Vice Chair, Assurance, EY
Pat Niemann, Partner, Americas Center for Board Matters, EY
Hermann Sidhu, EMEIA Assurance Deputy Leader, EY

Appendix 2: Reflection questions for audit committees

- ? What new risks are taking priority for your companies that were not present two or three years ago?
- ? How comfortable are you in your board's oversight of evolving external risks such as AI, cybersecurity, and geopolitical developments?
- ? How does your board assign risk oversight responsibilities?
- ? How are you ensuring effective coordination and communication with, and between, the various board committees in this complex risk environment? How confident are you that no key risk is falling through the cracks?
- ? How does your board and audit committee get informed about new risks arising or on the horizon?
- ? What is the level of alignment between the audit committee, board, and management on your company's risk appetite? How are conflicts dealt with?
- ? How does your board and audit committee get informed about risk mitigation actions and changes in risk prioritization ratings?
- ? How are you intentionally evolving the audit committee agenda, time allocation, and other ways of working to address new risks and the complexity of the current business environment?
- ? How do you assess your committee's capacity and overall effectiveness?
- ? To what extent have you pushed back on the board or the chair to reassign a particular item to another committee or the full board? What challenges did you encounter?
- ? To what extent have you considered overconfidence bias or other cognitive biases in your audit committee? What practical methods can be used to counter this bias?

Endnotes

[1] *ViewPoints* reflects the network's use of a modified version of the Chatham House Rule whereby names of members and their company affiliations are a matter of public record, but comments are not attributed to individuals or corporations. Italicized quotations reflect comments made in connection with the meeting by network members and other meeting participants.

[2] EY, *How Can Boards Prioritize Resilience to Build Trust and Create Value? Global Board Risk Survey 2023* (London: EYGM Limited, 2023), 3.

[3] Cravath, Swaine & Moore LLP, *SEC Adopts Cybersecurity Disclosure Rules for Public Companies* (New York: Cravath, Swaine & Moore LLP, August 1, 2023).

[4] Enda Curran and Alan Crawford, "In 2024, It's Election Year in 40 Countries," *Bloomberg*, November 1, 2023.