

EY Center for Board Matters 2024 Q2 audit committee update



PRESENTED BY THE EY AUDIT COMMITTEE FORUM

This quarterly update for audit committees provides a summary of key developments related to risk, financial reporting, and regulatory matters. For Q2 2024, audit committees are focused on shifting macroeconomic trends, possible supply chain disruptions and reconfigurations, the political environment (including elections in the US, the UK and elsewhere) and its impact on policy matters, and generative AI (GenAI) implications.

We expect audit committees will spend time discussing potential business implications arising from the November 5 US presidential election, including possible tax and regulatory policy impacts. Additionally, as organizations evaluate artificial intelligence (AI) use cases as the means to boost productivity and growth, there may be discussions around how organizations are building out their technology capabilities to capitalize on still-nascent use cases for GenAI.

Meanwhile, audit committees are also closely monitoring SEC-related activity. While the SEC issued an order staying its climate-related disclosure rules, audit committees are still keeping an eye on those proceedings as well as how companies will eventually comply with other new and emerging reporting requirements (e.g., California's climate laws and the European Commission's European Sustainability Reporting Standards (ESRS)).

Risk management

Given the ongoing changes in the business environment, it remains essential for audit committees to stay on top of critical risk drivers (e.g., political, economic, societal, technological, legal and environmental) and changing macroeconomic conditions to better assess the near- and longer-term risk implications to companies.

Organizations have been acting cautiously over the last six months with many either selectively slowing hiring and investment initiatives or freezing them altogether. This is primarily in response to complexity in the economic, policy and geopolitical environment, in which inflation seems to be moderating but cost fatigue persists.

Key risks to watch this quarter include:

- Escalating tensions in the Middle East are heightening the risk of further conflict; however, a variety of countries continue to seek diplomatic paths for regional stability. These hostilities could trigger energy price shocks, which could bring an unfortunate combination of higher inflation and lower growth. Companies and audit committees should plan for energy pricing volatility and the potential cost of capital impacts from such changes. For companies dependent on regionally sourced supply chains, operational challenges and supply chain disruptions/reconfigurations may be possible.

- The possibility of lasting inflation due to rising commodity prices, geopolitical tensions and escalating trade disputes is an ongoing concern. Concurrently, there is a risk that overly stringent monetary policy could lead to a swift tightening of financial conditions, which, coupled with increasing worries about the fiscal trajectory, may lead to a cutback in private sector activity. As the US elections draw near, the outlook for tax, trade and regulatory policies should be monitored closely.
- There may be upside risks stemming from noninflationary growth supported by a robust labor market and stronger productivity growth from efficiency improvements and GenAI.

Audit committees should consider discussing with management how these risks may impact financial reporting and related controls and disclosures. Additional conversations around scenario planning and risk mitigation, along with stress-testing assumptions surrounding these key risks, may be prudent.



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Key Q2 topic

Supply chain risks: how supplier risk has evolved and what organizations are considering

As businesses strive for an increased ROI in today's rapidly changing economic climate, there is a growing focus on supplier risk management. Dynamic global crises continue to challenge companies, with the escalation of conflict in the Middle East, the war in Ukraine and geopolitical complexities related to China.

Additionally, new regulations, coupled with increased return on investment targets, are helping reshape supply chain strategies and forcing businesses to focus on improving resilience. Previously, most organizations ranked their suppliers based on cost, quality, and speed of delivery. In 2024, we see companies incorporating more attributes into their supplier risk assessment, including resiliency elements to boost security and address environmental, social and governance (ESG)-related risks.

We are seeing an intersection of supply chain and ESG related risks – such as challenges related to greenwashing, the potential impacts to science-based targets (e.g., greenhouse gas (GHG) emissions) and social issues, including human rights and labor matters (e.g., forced labor). The legislative and regulatory landscape around sustainability is evolving rapidly, as more countries and regions implement laws and standards

to address the environmental and social impacts of businesses and their suppliers. Recent examples include:

Supply chain decarbonization

Several proposals and regulations related to supply chain decarbonization have been called out by governments and organizations.

- ▶ For example, a Biden executive order includes a directive to establish a “buy clean initiative” that prioritizes the use of lower-carbon American-made construction materials in US government procurement and federally funded projects.
- ▶ The European Union proposed a regulation called the “Carbon Border Adjustment Mechanism” that's aimed at reducing carbon leakage from EU-based companies to non-EU countries by imposing a carbon tax on certain imported goods that have a high carbon footprint.

Climate-related matters

California Senate Bills (SBs) 253 and 261, and Assembly Bill (AB) 1305 were signed into law on October 7, 2023.

- ▶ **SB 253:** The Climate Corporate Data Accountability Act requires public and private companies generating over \$1 billion in gross annual revenue doing business in California to disclose their Scope 1,

Scope 2 and Scope 3 emissions, as well as to obtain third-party assurance.

- ▶ **SB 261:** The Climate-Related Financial Risk Act requires public and private companies generating more than \$500 million in gross annual revenue doing business in California to disclose biennially climate-related financial risk and measures adopted to reduce and adapt to that risk, in alignment with the Task Force on Climate-related Financial Disclosures (TCFD) recommendations.
- ▶ **AB 1305:** The Voluntary Carbon Market Disclosures Act requires entities operating in California and making claims related to net-zero emissions, carbon neutral or carbon-neutral products, or significant

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GHG emissions reductions in California to disclose information about those claims and the purchase or use of voluntary carbon offsets to achieve those claims.

Relevant supply chain guidelines

Several proposals and regulations related to supply chain governance and forced labor have been called out by various governments and organizations.

- ▶ **German Supply Chain Act:** In June 2021, Germany passed a law that requires companies to conduct human rights due diligence on their own operations and on the third parties along their supply chain. The law applies from 2023 onward to companies with more than 3,000 employees and from 2024 onward to companies with more than 1,000 employees. Companies that fail to comply with the law may face fines, sanctions or civil liability.
- ▶ **Uyghur Forced Labor Prevention Act (UFLPA):** In December 2021, President Joe Biden signed into law a measure that bans the US import of any goods, wares, articles and merchandise mined, produced or manufactured wholly or in part in Xinjiang or by associated entities. The importer of record must provide documentation that the imported goods and their inputs are sourced completely from outside Xinjiang and have no connection to entities on the UFLPA Entity List, and this requirement is treated by Customs and Border Protection (CPB) as a

“rebuttable presumption” if goods are detained for inspection at the border.

- ▶ **Drug manufacturing supply chain transparency:** In November 2019, the Food and Drug Administration (FDA) issued guidance that outlines the expectation that drug manufacturers will confirm the quality and safety of their products and the third parties throughout their supply chains. The guidance emphasizes the importance of transparency, traceability and accountability of drug supply chain activities.
- ▶ **Corporate Sustainability Due Diligence Directive (CSDDD):** On February 23, 2022, the European Commission adopted a directive establishing a corporate sustainability due diligence duty. The core components are that companies are duty-bound to identify, assess and mitigate environmental and human rights impacts in their own operations, their subsidiaries’ operations, and their supply chains.

Audit committees will want to verify that management teams take appropriate action to identify which regulations apply to them, understand the key risks arising from complying with these regulations and put plans in place to mitigate these risks.

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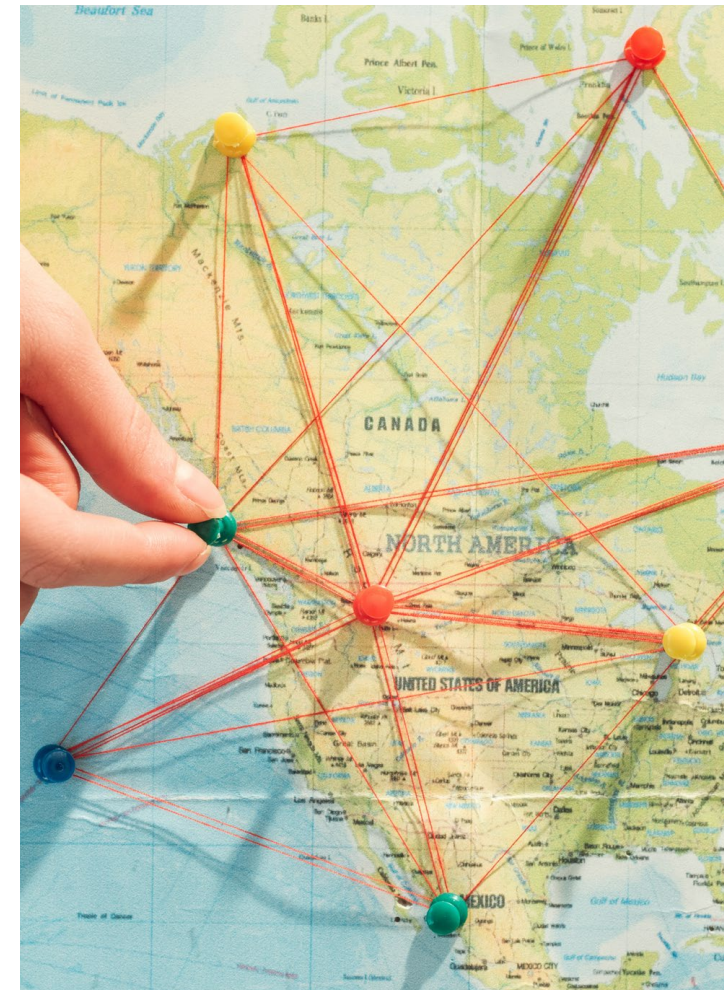
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advantage. Audit committees may consider encouraging management teams to implement leading practices for integrating additional risk dimensions into supplier risk management programs. Such practices may include:

- ▶ Identifying the supplier population most at risk (e.g., through inherent risk assessments) to focus assessment efforts on the right supplier base
- ▶ Selecting and collaborating with third parties that share a similar commitment or understanding of certain objectives and have strong capabilities and practices to improve the organization's own performance and innovation. For example, seeking ways to work with third parties to reduce costs and waste by optimizing resource efficiency and circularity; increase revenue and market share by offering green or social products and services; and foster innovation and differentiation by leveraging new technologies or business model
- ▶ Working toward reliable and consistent data on performance and impacts of third parties across certain key risk dimensions, as well as common standards and definitions for measuring and reporting, to enable comparison and benchmarking of third parties across different sectors, regions or issues
- ▶ Having formal, consistent processes and systems for assessing and monitoring key third-party risks. This includes conducting due diligence on highest-risk areas and entities using sources of information such as questionnaires, audits, certifications,

ratings, reports, and external data analysis. The assessment should cover current and potential issues and be tailored to the nature, complexity and criticality of each third-party relationship

- ▶ Monitoring that third parties are adhering to high standards of environmental stewardship, social responsibility and ethical conduct. This can be done using tools such as dashboards, scorecards, reports or alerts that track and measure the performance and compliance of third parties. The monitoring and management process should also include regular reviews, audits, feedback, remediation, and, if necessary, termination of third-party relationships based on performance.
- ▶ Having contingency plans and alternative sources of supply or service



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How GenAI may impact financial reporting and auditing

In a recent EY survey, nearly every CEO (95%) said they plan to maintain or accelerate transformation initiatives, including AI and other technologies, in 2024.

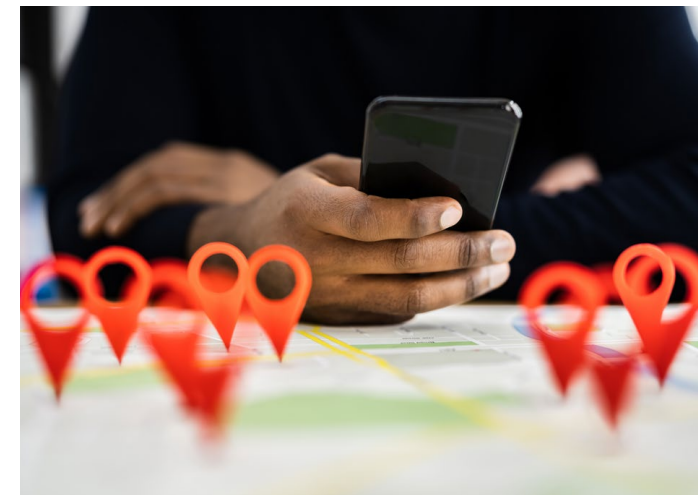
Meanwhile, institutional investors see responsible AI as an emerging engagement priority, and it's no surprise that directors rank innovation and evolving technologies as a top board priority in 2024.

While AI and machine learning are certainly not new technologies, GenAI has democratized AI through forms such as chatbots and large language models (LLMs). A recent survey from the Center for Audit Quality (CAQ) found that one in three audit partners see companies in their primary industry sector deploying or planning to deploy AI in their financial reporting process. This number is expected to rise as companies explore ways to leverage AI (and GenAI) to streamline and/or enhance accounting and financial reporting operations and processes. As an example, companies have started deploying/are planning to deploy GenAI to prepare the first draft of financial statement disclosures using prior-year disclosure(s), underlying schedules and general ledger data. Other

use cases of GenAI may include streamlining certain activities, such as drafting content, drafting code for reports used in financial reporting/close processes, summarizing data, working with unstructured data, etc. Furthermore, GenAI may be used to uncover trends, patterns and anomalies in large amounts of data that would otherwise be difficult or time-consuming for humans to complete manually.¹

Given the proliferation of this technology, the CAQ recently released its report [Auditing in the Age of Generative AI](#). This resource provides an overview of GenAI, including ways that companies are implementing this technology (including use cases), the regulatory environment, voluntary risk management frameworks and key audit considerations/risks/questions to consider related to deploying GenAI.

This CAQ resource document may be useful to audit committees as it highlights some of the key risks/issues to consider related to financial reporting and audit. It may also provide audit committees with key considerations to probe audit teams, both internal and external, around GenAI and the impact this technology may have on audit plans and procedures.



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¹ Adapted from the Center for Audit Quality report "Auditing in the Age of Generative AI," April 2024.

SEC rulemaking and other regulatory considerations

Rulemaking by the SEC has been relatively quiet during Q2. The SEC's climate disclosure rule continues to be considered by the 8th Circuit Court of Appeals, and the timing for resolution of the litigation is uncertain. Last quarter, the SEC stayed the new requirements pending judicial review.

While the stay may have dampened the sense of urgency in implementing the rules, audit committees should encourage companies to continue to focus on climate disclosures. The SEC may continue to issue comment letters addressing compliance with its 2010 guidance on climate disclosures. Also, many public companies may become subject to climate disclosure requirements under laws and regulations enacted in states such as California and in other jurisdictions, such as the European Union. The stay may provide companies more time to consider which controls they currently have in place to support climate-related statements and which controls they would need to put in place under the new rules.

On the enforcement front, the SEC continues to warn companies against AI-related disclosures that are false or misleading. Related to the SEC's recently adopted cybersecurity rules, the director of the Division of Corporation Finance issued a statement clarifying that if a company chooses to voluntarily disclose a cybersecurity incident for which it has not yet made a materiality determination or for an incident that it has

determined is immaterial, it should do so under a Form 8-K item number other than 1.05 (which is reserved for material cybersecurity incidents) to avoid any confusion for investors.

During the quarter, the Public Company Accounting Oversight Board (PCAOB) issued several proposed and final standards and rules aimed at providing information for investor and audit committee decision-making. Of particular note to audit committees, the PCAOB's proposed [firm and engagement metrics](#) standard would mandate public reporting of 11 standardized firm- and/or engagement-level measures for investor and audit committee analysis and comparison. Engagement-level reporting would be required for every audit of an accelerated or large accelerated filer. The 11 metrics cover staff management, resource allocation, staff experience and continuity, quality and risk management, compensation and performance. The proposal would allow firms to provide no more than a 500-character narrative disclosure per metric. Management and audit committee members should be aware of the proposed public disclosure of metrics specific to their company's audit. The comment period closed on 7 June 2024.

Additionally, the PCAOB released a staff "Spotlight" report that highlights considerations for auditors related to commercial real estate as they plan and conduct audits and reviews of interim financial information in industries with exposure to commercial

real estate amid reduced demand for office space and retail space in surrounding neighborhoods due to the shift to hybrid and remote work in many industries. The report noted that the current conditions in the commercial real estate industry may require enhanced communications between auditors and audit committees (e.g., changes to certain accounting policies, practices or estimates as a result of the current business environment, significant changes to planned audit strategy, fraud risks). Audit committees associated with industries exposed to commercial real estate should consider reviewing this report as they prepare for meetings with their external auditors.

Additional resources

- ▶ [SEC in Focus](#), April 2024
- ▶ [Technical Line – How the climate-related disclosures under the SEC rules, the ESRS and the ISSB standards compare](#), June 2024
- ▶ [Technical Line – A closer look at the SEC's climate-related disclosure requirements](#), April 2024
- ▶ [Technical Line – A closer look at California's recently enacted climate disclosure laws](#), April 2024
- ▶ [SEC top five: What public companies, boards and investors should watch for in 2024](#), February 2024

Questions for the audit committee to consider

In discussions with management, compliance personnel and internal and external auditors, audit committees should consider the following in addition to standard inquiries:

Risk management-related inquiries

- ▶ How strong are the organization's capabilities to be highly informed about the internal and external environment, and risks, events and opportunities that may influence or compromise enterprise resilience?
- ▶ How effective is the board's oversight of emerging risks and other evolving external risks such as geopolitical developments, uncertain economic conditions, and climate risk? Does it have the information, expertise and professional skepticism it needs to challenge management in these areas?
- ▶ Are stress tests performed to evaluate whether the company's financial reserves can absorb distress in the economy? Does the organization have confidence in the financial strength of its counterparties?
- ▶ Does the organization deploy future scenario-planning to inform its long-term planning process to enable rapid adaptation during changing circumstances?
- ▶ Who (individual or group) in the company is responsible for oversight of the use of GenAI? Has management developed a framework for responsible use of GenAI? Has management established policies regarding the acceptable and ethical use of GenAI?

Does the company have a process to track and monitor the use of GenAI throughout the company, including use by third-party service providers? How does the company evaluate the impact (nature and affected groups) of GenAI technologies being deployed?

- ▶ What are the applicable laws and regulations impacting the company's use of GenAI technologies? Does the company have contractual agreements that may impact how the company can use GenAI technologies? Has the company performed a regulatory, legal and contractual compliance assessment to understand considerations for the design, deployment and use of GenAI technologies? If the company uses GenAI technologies developed by a third party, is the company able to obtain sufficient information from the provider regarding compliance with applicable laws, regulations and contractual obligations? How does the company monitor GenAI technologies over time to determine whether bias has been introduced through the algorithms or the data that could result in noncompliance with laws, regulations and contractual obligations?
- ▶ Has the company identified specialized skills or knowledge needed to assist with oversight, development, deployment, operation and monitoring of GenAI technologies?
- ▶ How has management considered GenAI technologies in its fraud risk assessment? Has the

company identified new incentives, opportunities or pressures to commit fraud due to the deployment of GenAI technologies?

- ▶ How does management consider data privacy risks when selecting or developing GenAI technologies? Does the company use a public instance of GenAI technologies that tracks and saves inputs and data that are accessible by third parties or a private instance where inputs and data are tracked and saved only by the company?
- ▶ How does the company consider cybersecurity risks when selecting or developing GenAI technologies? Has the company performed a cybersecurity risk assessment to evaluate threats and safeguards?
- ▶ How does the company monitor the ongoing effectiveness of GenAI technologies for the intended

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purpose? How does the company monitor changes to GenAI technologies? How does the company determine the appropriate level of human-in-the-loop involvement with GenAI technologies? How does the company consider explainability and interpretability needs of users to enable effective human-in-the-loop involvement with the GenAI technology?

- ▶ How is management understanding and monitoring the effectiveness of risk management of critical third parties with respect to financial and operational resiliency, IT security, data privacy, culture and environmental, social and governance factors?
- ▶ Is there an appropriate level of robustness and redundancy provided for critical third parties to minimize service disruption(s)?
- ▶ How does management evaluate and categorize identified cyber and data privacy incidents and determine which ones to escalate to the board?
- ▶ Has the board participated with management in one of its cyber breach simulations in the last year? How rigorous was the testing? What changes were implemented by the organization as a result?
- ▶ Has the company leveraged a third-party assessment to validate that the company's cyber risk management program is meeting its objectives? If so, is the board having direct dialogue with the third party related to the scope of work and findings?
- ▶ As a result of the NIST CSF 2.0 adding a new “govern” function, how have the organization’s risk management strategy, expectations and policies evolved?
- ▶ What actions has management taken to verify that the company's cybersecurity policies, procedures, risk assessment and practices align to NIST CSF 2.0?
- ▶ Has management performed a gap analysis of the current cybersecurity program against the new NIST CSF 2.0 and communicated the results and remediation items to the board?
- ▶ Given the NIST CSF 2.0 emphasis of utilizing a risk-based approach, how has this impacted the company's cybersecurity risk assessment process, appetite and risk posture?
- ▶ Is the organization equipped to respond to any crisis scenario and operate/deliver services at the minimally acceptable levels? Does the organization test/flex its resilience against a range of operational and strategic scenarios?
- ▶ How has the company identified the environmental and social factors that are material to the business? Has it conducted a recent sustainability materiality assessment and disclosed the results?
- ▶ How has the company integrated material ESG factors into strategy development and enterprise risk management? Do company communications successfully tie those ESG factors to strategic and financial results?



“ Given the NIST CSF 2.0 emphasis of utilizing a risk-based approach, how has this impacted the company’s cybersecurity risk assessment process, appetite and risk posture? ”

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- ▶ How is management progressing with its analysis of the impact of the OECD Pillar Two global minimum tax model? In particular, what impact do the rules have on the estimated annual effective tax rate (ETR) for 2024 and is management monitoring proposed tax legislation in those countries that have yet to adopt the Pillar Two rules for potential impact on the projected ETR?
- ▶ How is the company progressing in its systems and control enhancements that will be required to calculate the Pillar Two impacts, including analyzing the safe harbor rules and producing separate entity financial statements for the calculations. Is management planning any internal restructuring transactions to mitigate the increased worldwide taxes that may be occurring as a result of the Pillar Two impacts on the entire group?
- ▶ Has management analyzed the impact that the Pillar One tax regime may have on its intercompany transfer pricing policies, and will it be an early adopter of the OECD transfer pricing regime inherent in Pillar One?
- ▶ Does management have the resources within the tax function to keep pace with, and evaluate the impacts to the company of the OECD global minimum taxation, and new environmental/carbon taxes being legislated globally on a quarterly basis?
- ▶ Have there been any meaningful changes to the company's key policies, any material exceptions granted or any unusual allowances to any compliance provisions?

Accounting, disclosures and other financial reporting-related inquiries

- ▶ What nonrecurring events and circumstances have transpired and what are the related financial reporting and disclosure implications?
- ▶ Are the company's nonfinancial disclosures fit for purpose given current investor stewardship priorities, investing trends and related investor data needs?
- ▶ Has the company developed accounting policies to guide climate-related financial statement disclosures in a manner consistent with the new SEC climate rules?
- ▶ What additional processes, resources, and controls will be needed to comply with the new SEC climate rules?
- ▶ Does the company have sufficient disclosure controls and procedures over nonfinancial climate-related data? Is internal audit providing any type of audit coverage on ESG-related data and/or is the company obtaining any external assurance?
- ▶ If ESG-related matters are being discussed in more than one place (e.g., SEC filings, earnings releases, analyst communications, annual report and shareholder letter, corporate social responsibility report), is there consistency in the disclosures?
- ▶ Has the company evaluated its disclosures in light of Institutional Shareholder Services' addition of 11 cyber-specific inquiries related to cyber risk?

- ▶ How is the organization proactively assessing the opportunity to enhance stakeholder communications, including corporate reporting to address changes in operations and strategies as well as changing stakeholder expectations?
- ▶ Has the company developed internal controls for the Pillar Two regime, if applicable, that will be ready for testing in Q3 of 2024 at the latest?
- ▶ Have there been any material changes to internal controls over financial reporting or disclosure controls and procedures to address the changing operating environment? Have any cost-saving initiatives and related efforts impacted resources and/or processes that are key in internal controls over financial reporting? If so, has management identified mitigating controls to address any potential gaps?

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Has the company developed accounting policies to guide climate-related financial statement disclosures in a manner consistent with the new SEC climate rules?



Inquiries to auditors

External auditors

- ▶ Does the engagement team expect significant changes in hours or staffing mix from previous audits? Why or why not?
- ▶ Did the engagement team notice any red flags arising from management responses? How has the engagement team considered changes to the incentive, opportunity, and rationalization of the fraud triangle?
- ▶ What plans does the auditor have to assess the company's accounting for Pillar Two taxes and when will it begin testing relevant internal controls?
- ▶ What audit challenges does the team anticipate in relation to the newly adopted SEC climate rules or other applicable ESG-related reporting requirements (e.g., California climate laws, European Commissions ESRS)?

Internal auditors

- ▶ How should audit plans be adjusted to address the newly released NIST CSF 2.0 framework? What changes and implementation challenges are expected from the application of this updated framework?
- ▶ If the company is subject to the Pillar Two, what processes and controls will it need to adequately capture the data needed to calculate the taxes under

the new regime? Has the company taken action to establish those processes and controls are ready for testing?

- ▶ What is the company's state of readiness to comply with the newly adopted SEC climate rules?
- ▶ What action(s) is internal audit taking to align with the Institute of Internal Auditors' Global Internal Audit Standards? Has the organization conducted a gap assessment to understand the magnitude of change to conform with the 2024 global audit standards?
- ▶ What internal audit processes need to be changed or adjusted due to the new standards?
- ▶ Does internal audit currently have the resources and capabilities to conform with the new standards?
- ▶ Is there a plan to upskill the internal audit function to understand the new standards and related impacts?
- ▶ When will internal audit be ready to demonstrate conformance with the new standards?
- ▶ What changes can the board expect to see during the implementation period?



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US SCORE no. 23754-241US
CS no. 2406-4552999

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