EY Center for Board Matters

What audit committees need to know for year-end 2021 and beyond

Building a better working world

Introduction

What audit committees need to know for year-end 2021 and beyond

This 2021 edition of our annual review of issues affecting audit committees during the year-end audit cycle summarizes key considerations for audit committees. With the changing risk landscape, the audit committee's role continues to grow more demanding and complex amid the pandemic and a dynamic business environment. This report will assist audit committees to proactively address developments in risk management, financial reporting, tax, and the regulatory landscape.

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Risk management

After a protracted period of operating in survival and stabilization mode, organizations are now turning their attention to enhancing enterprise resiliency, growth and transformation. A recent EY study noted that 68% of organizations plan a major investment in data and technology in the next 12 months, and 61% plan to undertake a major transformation initiative.

Boards and audit committees are revisiting risk management practices to see that risks are managed effectively across the organization. They're also building more resiliency toward low likelihood and high-impact risks, including the ability to rapidly restore business operations. Given the likely continued waves of disruption ahead, leading organizations are making investments to drive resiliency into their long-term strategies and operating models.

A growing focus on enterprise resiliency

The rapidly changing economic conditions, including inflationary pressures and ongoing supply chain disruption, have made understanding the current business environment and predicting future conditions challenging — especially since the economic recovery remains uneven across geographies and sectors. Over the last 18 months, resilience across these existing and new risk dimensions has become a defining characteristic of long-term success and a key business imperative for organizations globally. Financial and operational resilience were rigorously tested, and those who had built greater and higher-quality capital and liquidity were in stronger positions going into the pandemic. The need for greater technological resilience was driven by greatly accelerated moves to transform digitally. Human capital issues, workforce resiliency and employee well-being became key focus areas. At the same time, societal and environmental resilience became an elevated focus as organizations paid closer attention to diversity and equity in society and the accelerating impacts of climate change.

Whether due to growing regulatory pressure or the disruptions caused by COVID-19, risk management has climbed higher on the board agenda. We recently surveyed 510 global directors to uncover the views and perceptions of directors on enterprise risk management within their organization and the hallmarks of effective risk management, and identify the actions boards can take to improve risk oversight.

Some notable survey highlights include the following:

- COVID-19 was not only a major risk event in itself — it was also an accelerator of risks that were already omnipresent, including cybersecurity attacks, supply chain disruption, geopolitical tension, and other external threats. Nearly 83% of board members believe market disruptions have become increasingly impactful, and 87% believe they have become increasingly frequent.
- Core attributes of high-performing risk management leaders include three key behaviors: risk is viewed through a long-term horizon (ideally more than five years); risk management priorities are aligned with business strategy; and there is a greater focus on managing emerging risks, atypical risks and external risks.
- Directors rank unfavorable economic conditions, technology and digital disruption, and changing customer expectations as the top three risks that will moderately impact their business during the next 12 months. Additionally, changing customer expectations, climate change and sustainability, and changes in the regulatory environment are noted as the top three risks that have grown in importance as compared with the prior year.
- Directors noted a misalignment between corporate culture and strategy as the greatest workforce-related risk management challenge. Given the hypercompetitive labor market and the need to contend with business transformations, it is not surprising that board oversight of talent and culture has risen in importance. In fact, our study shows that 80% of companies considered leaders on risk management often or always talk at board meetings about the culture needed to support the organization's strategy.
- Despite the criticality of risk management, many board members lack confidence in their organization's capabilities. For example, just 18% believe that their organization's disaster response and contingency planning is highly effective, and only 13% believe that their organization is highly effective at embedding risk and compliance activities.

As companies build enterprise resiliency and revisit their risk management practices, audit committees and boards should continue to monitor the risk landscape and assess implications to the company.

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Key priorities of the Biden administration

As audit committees and boards navigate fast-moving policy developments and a dynamic political environment, understanding policy and geopolitical forces and their impact on strategy and risks has become critical. Key considerations that may impact public companies in light of the evolving public policy landscape are as follows:

Competition

The Biden administration has established a policy goal to promote competition in the US economy and reduce corporate consolidation. President Biden signed an executive order (EO) in July on corporate consolidation and anticompetitive practices in various markets, including labor, health care, transportation, agriculture, internet service, tech platforms, and banking and consumer finance. The order also created the White House Competition Council, tasked with coordinating, promoting and advancing federal government efforts to address overconcentration, monopolization and unfair competition affecting the US economy. The EO does not impose new requirements on the business community, but instead encourages agency heads to adopt policies through rulemakings that push back against corporate consolidation. In Congress, there is bipartisan interest in reinvigorating antitrust laws, specifically in relation to the tech sector, although legislative progress has stalled due to disagreements over approach. Companies should monitor developments regarding antitrust reform and be prepared for increased scrutiny of M&A activity across sectors.

Cybersecurity

The Biden administration has been active in seeking to strengthen cybersecurity, particularly in light of several recent high profile cyberattacks on companies and the federal government. In addition to issuing an executive order aimed at strengthening the US government's cybersecurity defenses, the Biden administration is working with stakeholders to promote voluntary efforts by the private sector to strengthen their cyber defenses and collaborate with the government in combating ransomware. Cybersecurity is also on the radar of Congress and federal financial regulatory agencies, including the Securities and Exchange Commission (SEC), which is developing a proposed rule to require new disclosures relating to cybersecurity risk governance. Companies should consider whether their cybersecurity defenses need to be strengthened and monitor regulatory and legislative developments in this area.

Supply chain

The resiliency of US supply chains is another area of focus for the Biden administration in light of shortages of critical materials during the pandemic and beyond. In June 2021, the administration released findings from a 100-day interagency domestic supply chain assessment of four critical products — critical minerals, large-capacity batteries, pharmaceuticals and semiconductors — and outlined steps it will take to strengthen those supply chains and shore up domestic manufacturing. In addition to the 100-day review, the administration also is undertaking yearlong reviews of six broader sectors, which will be published in February 2022. These sectors are agricultural commodities and food production, defense, energy, information and communications technology, public health, and transportation. Companies in these sectors should monitor potential policy shifts ranging from government tax incentives to restrictions such as export controls. Companies may also consider conducting scenario analyses in relation to diversifying, insourcing or retaining domestic supply chain capabilities. ▶

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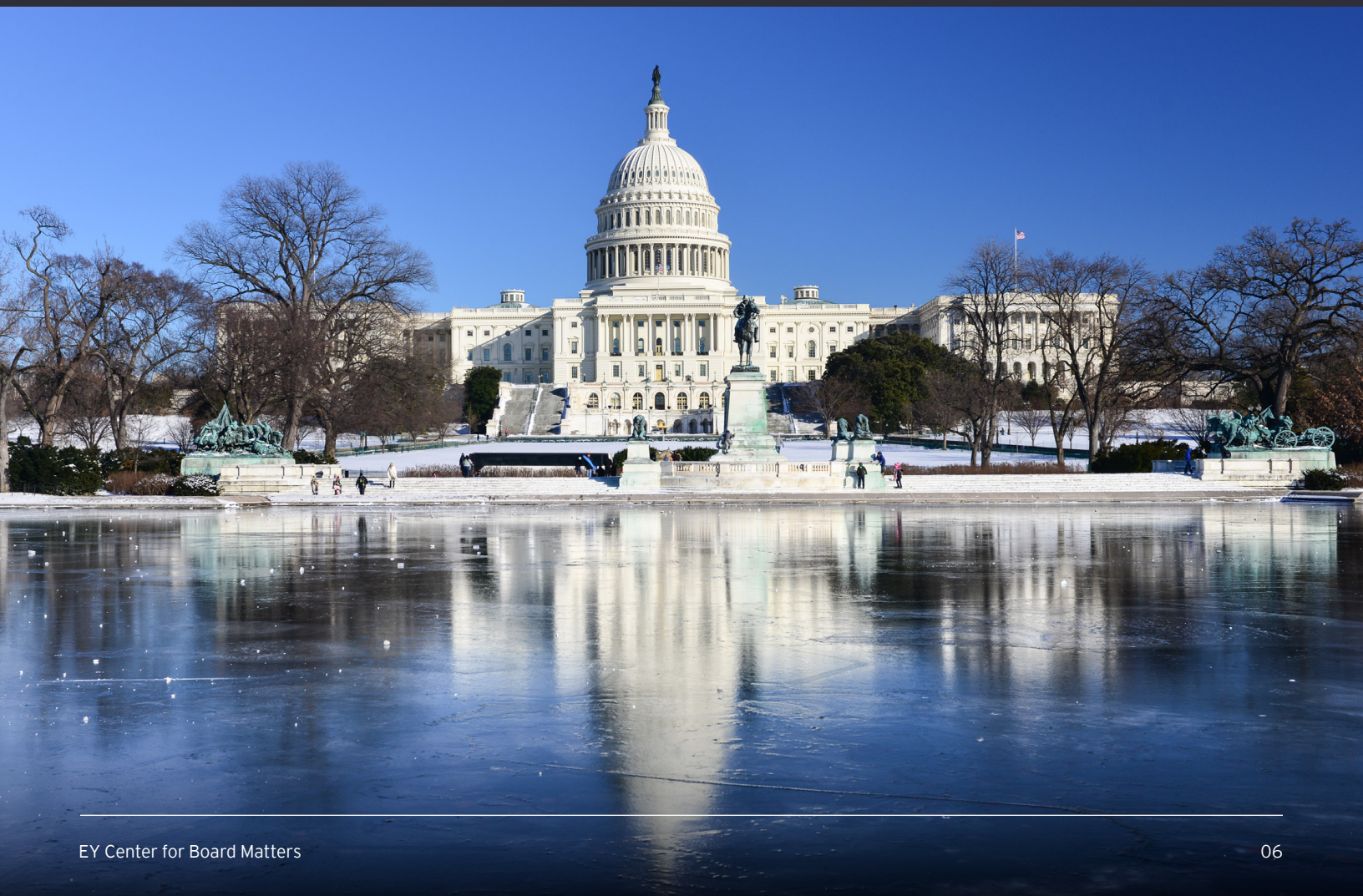
Sustainability

Companies should consider a comprehensive assessment of their risks, opportunities and disclosures associated with climate change given the increase in regulatory focus on these areas.

- Early in his administration, President Biden issued an executive order on climate-related financial risk to encourage financial regulators to strengthen supervision of climate-related risk, including through disclosures. The order also directed the Financial Stability Oversight Council (FSOC), comprising the heads of US financial regulatory bodies, to issue a report on the impacts of climate change on the US economy. The report states that climate change is an emerging threat to the country's financial system and provides a series of recommendations about how to address the risks and opportunities to the financial system of transitioning to a less carbon-intensive economy. The recommendations include new SEC disclosures on climate-related risks, which are currently being drafted. Financial institutions should monitor regulatory developments as other FSOC members continue to address climate change as well.
- On the legislative front, congressional Democrats have followed the administration's lead and made climate and social development a key focus area. In November, President Biden signed into law the Infrastructure Investment and Jobs Act, a $1.2 trillion bill that included $150 billion for clean energy and climate change protections to be allocated over the next five years. Meanwhile, congressional Democrats are also working to pass the Build Back Better Act (BBBA) via budget reconciliation. The proposed legislation, which is still subject to change, could include more than $500 billion in spending for clean energy and climate programs, the largest legislative investment to combat climate change in US history. The BBBA also aims to significantly cut greenhouse gases by 2030, establish a civilian climate corps and advance environmental justice as part of the president's Justice40 initiative. Companies should monitor potential investment and collaboration opportunities in green industries and climate-resilient infrastructure.

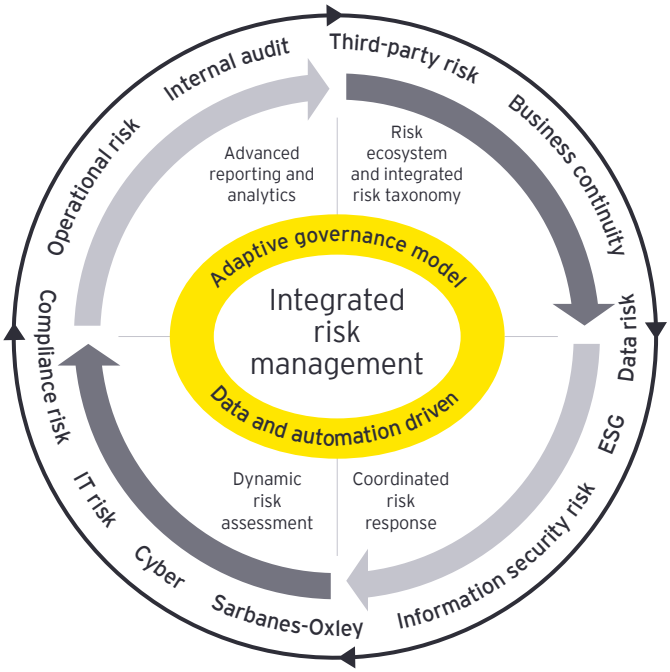


How data and technology are enabling integrated risk management

Despite its elevated importance, organizations' risk monitoring and mitigation efforts currently fall short of boards' expectations. In fact, just 49% of CEOs say their risk assessment processes are adequately data-driven. Organizations that prioritize the development of an integrated risk management platform effectively embrace the momentum created by data and technology to drive agility and enhanced risk-based decision-making into their risk management approach. The outcome is a coordinated and proactive view of the top risks faced by the organization. We highlight trends and ways that organizations are leveraging data and technology to enable and enhance integrated risk management efforts:

- Leading organizations are leveraging automation technology to process low-value manual tasks, such as risk model verification and simple data process, allowing the risk function to focus on value-adding activities (e.g., evaluating new business models or assessing threats associated with their organization's deployment of new technology). Automated data collection and monitoring are enabling these organizations to identify real-time potential issues to risk and business teams much sooner and provide a broader and connected perspective on control effectiveness and risk.
- Businesses are utilizing artificial intelligence (AI) to assist in modeling and understanding connections between risks (e.g., using AI to automate basic risk research, identify important risk statements in unstructured documentation and undertake casual analysis to identify risk interdependencies). These insights can then be presented in easy-to-comprehend formats via dashboards to senior management and boards. Importantly, an improved understanding of the intricacies of risk helps to develop more effective mitigation measures and improved coordination for deploying resources across risk functions.
- Integrated risk management platforms and cloud infrastructure are enabling teams to analyze risk trends more easily and providing risk teams the data storage capacity and analytics firepower needed to conduct horizon scanning, scenario planning and stress testing based on multiple variables. Boards and audit committees who are looking for teams to effectively detect weak signals of an atypical and distant threat before it materializes into a major risk are seeking this type of analysis.

Boards and audit committees should assess whether management has a robust strategy for an integrated risk management program leveraging data and technology, with a particular focus on talent and skillsets that may be required.



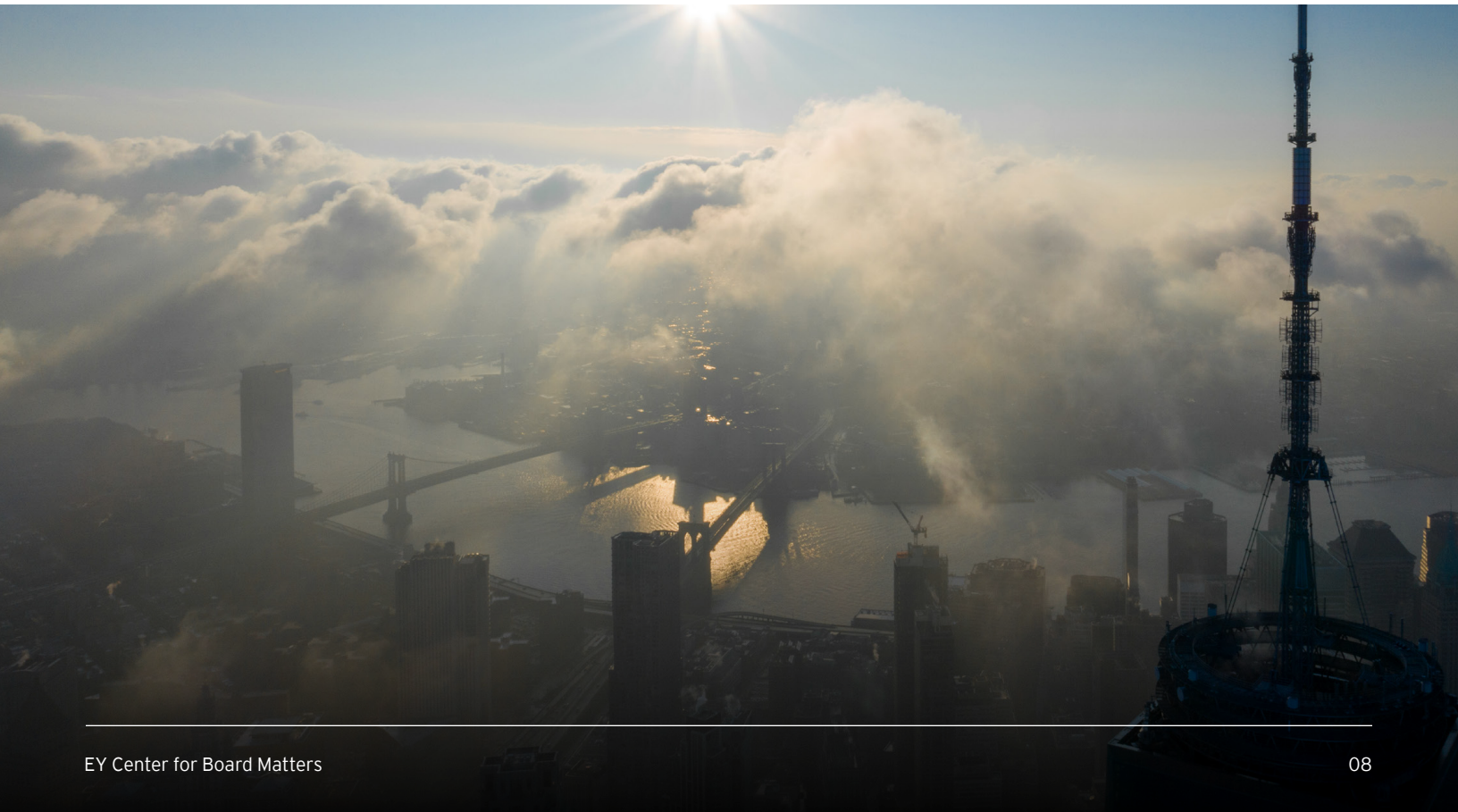
> Organizations that prioritize the development of an integrated risk management platform effectively embrace the momentum created by data and technology to drive agility and enhanced risk-based decision-making into their risk management approach.

How oversight of cybersecurity continues to evolve

As the cyber attack surface increases, threats and incidents continue to intensify, creating more pressure than ever for companies. According to the EY Global Information Security Survey 2021, 81% of executives say the COVID-19 pandemic forced organizations to bypass certain cybersecurity processes or controls.

In this environment, boards and audit committees should remain vigilant and enhance their oversight over cybersecurity by:

- **Setting the tone.** Establish cybersecurity as a key consideration in all board matters.
- **Staying diligent.** Address new issues and threats stemming from remote work and the expansion of digital transformation. Assess how data protection and governance can be improved.
- **Determining value at risk.** Reconcile value at risk in dollar terms against the board's risk tolerance, including the efficacy of cyber insurance coverage.
- **Embedding security from the start.** Embrace a "trust by design" philosophy when designing new technology, products and business arrangements.
- **Independently assessing the cybersecurity risk management program.** Obtain a recent and rigorous third-party assessment of the cybersecurity risk management program with the external independent advisor's direct feedback presented to the board.
- **Understanding escalation protocols.** Include a defined communication plan detailing when the board should be notified, including ransomware incidents.
- **Managing third-party risk.** Understand management's processes to identify, assess and manage the risk associated with service providers and the supply chain.
- **Updating cybersecurity and integrity training for employees and contractors.**
- **Testing response and recovery.** Enhance enterprise resiliency by conducting rigorous simulations, including restoring off-site backups and testing recovery time and arranging protocols with third-party specialists before a crisis.
- **Monitoring evolving practices and the regulatory and public policy landscape.** Stay attuned to evolving oversight practices, disclosures, reporting structures, metrics, and regulatory and public policy developments.



How internal audit (IA) functions are transforming

Going forward, boards and audit committees will not be content with an IA function that continues to do business as usual while dynamic shifts are occurring throughout the organization. The growing "digital and data divide" between IA and the business within organizations will continue to challenge the relevance of IA and compliance functions.

Both executives and audit committees are evaluating the effectiveness of their IA function and exploring changes to the way the function operates in the future. Since the pandemic, a different picture of IA has been emerging as the function becomes more dynamic and draws on an expanded skill set. Traditional audit methods such as on-site visits, sample-based testing and documentation reviews are giving way to remote audits, analytics-based testing and digital audit techniques. The COVID-19 disruption is accelerating the transformation of IA to become an agile, forward-looking and technology-enabled business partner that provides strategic insight on risk across the organization. In particular, leading IA functions are performing the following:

- **Disrupting the risk assessment process:** shifting from a static, single point-in-time view of risk to dynamic, technology-enabled risk identification and prioritization that is refreshed continuously in real time. IA functions are also leveraging collaboration tools to facilitate efficient and timely feedback from key stakeholders and exploring the use of tools and enablers to identify outside risks.
- **Adopting continuous monitoring:** broadening the focus from detection based on past results to also predicting control failures and risk triggers in real time. Additionally, leading IA functions are implementing a data analytics platform that monitors key risk indicators throughout the organization and enhances risk management by enabling the first and second lines to continuously monitor baseline risk. This is allowing IA to optimize its audit approach and focus on emerging risks.
- **Communicating with impact:** transforming the way that IA communicates with its stakeholders by focusing on delivering insights over simply reporting results. IA functions are focusing their communications of findings on the root cause of the issue, providing the business with valuable wisdom and insight that can be used to enact real change and improvement. Progressive IA functions are also using interactive reporting dashboards, which allow for quicker turnaround of results, better engagement with the user and more impactful conversations than traditional audit reports.

A dynamic IA function — digitally enabled and agile

Sharpening the focus on culture, ethics and compliance-related risks

In the current environment, businesses may have been forced to take quick actions without following normal protocols and due diligence. Governments around the world are sending aid to companies with minimal safeguards. Many employees are working remotely with less security and supervision while under far more stress, increasing the opportunities for fraud. Organizations without a strong antifraud program and appropriate cybersecurity may face increased compliance risks, such as legal action and regulatory fines.

All types of occupational fraud rose in 2020, and 90% of certified fraud examiners expect a further increase in 2021, according to a global ACFE survey.[1] Examiners cited cyber fraud as the top risk, with payment fraud, bribery, corruption, and employee embezzlement also on the increase. As the post-crisis landscape promises some relief as well as more change, audit committees should assess how fraud risks may have grown during the pandemic and assess whether the current control environment is sufficient. Audit committees should verify that organizations are looking beyond short-term fixes and enhancing current processes and policies to make them stronger long after the pandemic ends. We offer the following practices for audit committees and management to consider:

- Identify areas that are most likely to be impacted by fraud and prioritize them for improvement, such as third-party controls and lack of cybersecurity for remote workers.
- Maintain a strong culture of corporate integrity, understanding that adjustments may be needed to engage and support a remote workforce.
- Closely monitor and keep a pulse on how culture can affect internal controls and compliance — this includes consideration of analytics of cultural trends, benchmarking to other entities or standards, "lessons learned" analyses, reviews of behavioral trends, and surveys of risk attitudes and risk awareness.
- Consider how AI, advanced analytics and automation can be leveraged to stay ahead of sophisticated cyber threats and detect patterns that indicate wrongdoing.
- Evaluate changes to third-party risk due to the changing environment, considering new controls, contracts, and other measures to improve data protection and stem corruption.
- Evaluate the effectiveness of the organization's whistle-blower reporting processes.
- Stay abreast of evolving regulations to maintain compliance and reduce penalties should data breaches and other wrongdoing occur.

[1] "Fraud in the wake of COVID-19: Benchmarking report — December 2020 edition," Association of Certified Fraud Examiners (ACFE), December 2020.

Additional resources

- EY Global Board Risk Survey
- How cybersecurity risk disclosures and oversight are evolving in 2021

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Financial reporting

Companies are continuing to re-evaluate their disclosures as stakeholders seek to understand the impact of various external developments on the business. This includes the continued global COVID-19 pandemic-driven economic uncertainty, climate and other environmental, social and governance (ESG) factors, and evolving geopolitical developments.

We highlight some of these and other key financial reporting developments and trends to assist audit committees in driving audit quality and encouraging an environment and a culture that support the integrity of the financial reporting process.

Continue to focus on accounting and disclosure issues related to the pandemic

As organizations adapt to the uneven economic recovery and variants of the pandemic within and outside of the US, we anticipate audit committees will continue to evaluate these evolving impacts and changes in the business environment on their financial reporting processes. Key considerations may include the following:

- Evaluate and consider thorough disclosures in areas such as changes in internal control over financial reporting, management discussion and analysis (e.g., impacts of labor shortages and labor market conditions, inflationary pressures), risk factors, critical accounting estimates, liquidity, and current vulnerabilities due to certain concentrations (e.g., customer, supplier, geographic).
- Reevaluate earnings and other performance or financial position guidance previously provided and the ability to provide future guidance.
- Reevaluate the use of non-GAAP measures and consider whether any changes in non-GAAP financial measures (or key performance indicators) are appropriately disclosed and consistently applied in all periods.
- Obtain an update on how management communicates, monitors and enforces insider trading and Regulation FD policies, including whether those policies have changed or may need to change to address material undisclosed business developments.

Companies should continue to update their disclosures about the effects of the pandemic, current market conditions and their expectations for the future. It will be important for audit committees not only to understand management's view of future economic conditions, but also validate that the organization provides transparent disclosures regarding these views.

"Companies should continue to update their disclosures about the effects of the pandemic, current market conditions and their expectations for the future.

What we're seeing in SEC comment letter trends

The SEC staff continues to focus on many of the same topics that we highlighted last year. The chart below summarizes the top 10 most frequent comment areas in the current and previous years.

In our review of SEC staff comment letters on periodic reports, we also found that the volume of SEC staff comment letters continued to decline and was down 20% from the previous year. During the year, the SEC staff issued a number of comments addressing disclosures about the COVID-19 pandemic. The staff focused on the specificity of a company's disclosures of risk factors and the effects of the pandemic on MD&A, fair value measurements and non-GAAP financial measures.

In addition, as part of its increased focus on disclosures related to ESG matters, the SEC staff has issued comments on climate-related disclosures, including considerations of its 2010 guidance (see below for further discussion).

Looking ahead, we expect the SEC staff to:

- Continue to monitor how registrants address the accounting and reporting implications of the COVID-19 pandemic, including their accounting for past and future government relief.
- Possibly comment on how companies apply the amendments to Regulation S-K pertaining to MD&A.
- Potentially comment on priority topics reflected in the SEC's regulatory agenda, such as disclosure related to climate risk, human capital such as workforce diversity and corporate board diversity, and cybersecurity risk governance.
- Potentially ask how registrants have considered whether to disclose the material effects of risks related to changes to their business that may be necessary to respond to climate risk. These risks could affect registrants' disclosures about their business, financial condition and results of operations (e.g., new policy and regulatory changes). The SEC staff may also ask registrants whether the information included in their sustainability reports should also be included in their annual reports.

Audit committees should continue to understand SEC comment letter trends in order to be better informed and identify disclosure improvements for the management team to consider.

	Ranking 12 months ended June 30*		Comments as a percentage of total registrants that received comment letters*
Comment area	**2021**	**2020**	**2021 and 2020**
Non-GAAP measures	1	1	37%
Management's discussion and analysis (MD&A)**	2	2	37%
Segment reporting	3	4	17%
Revenue recognition	4	3	19%
Fair value measurements***	5	5	8%
Signatures/exhibits/agreements	6	10	6%
Goodwill and intangible assets	7	6	7%
Contingencies	8	7	5%
Inventory and cost of sales	9	8	5%
Income taxes	10	9	4%

* These rankings are based on topics assigned by research firm Audit Analytics for SEC comment letters issued to registrants with a market cap of $75 million or more about Forms 10-K and 10-Q from July 1, 2019 through June 30, 2021. In some cases, individual SEC staff comments are assigned to multiple topics, if the same comment covers multiple accounting or disclosure areas.

** This category includes comments on MD&A topics, in order of frequency: (1) results of operations (68%), (2) critical accounting policies and estimates (15%), (3) liquidity matters (14%), and (4) business overview (3%).

*** The majority of the SEC staff's comments on fair value measurements are related to goodwill impairment analyses.

Revisiting the SEC's guidance on climate change disclosures in today's environment

Given the SEC's increased focus on disclosures related to climate change and other ESG matters, companies should reevaluate their disclosures related to these matters. The SEC staff in the Division of Corporation Finance (DCF) has been issuing comment letters to assess compliance with the SEC's 2010 guidance on climate-related disclosures. A task force has been created in the Enforcement Division to pursue potentially misleading ESG disclosures or omissions of material information related to these matters.

The SEC's DCF posted a sample comment letter on its website to illustrate the types of comments it has issued to companies regarding their compliance with the SEC's 2010 guidance on climate-related disclosures. We expect the DCF staff to continue to address issuers' climate-related disclosures through the comment process even while rulemaking on this topic is underway. Audit committees should verify that management has considered the 2010 guidance and continues to reevaluate the company's disclosures as their businesses evolve.

Beyond the SEC's focus on climate, audit committees should be aware that a growing number of investors are making net-zero commitments. Accordingly, investors are putting significant and increasing emphasis on their portfolios' exposure to climate change and incorporating climate data into investment decision-making. Our sixth global institutional investor survey found that 77% of investors will devote considerable time and attention to evaluating physical climate risk implications when they make asset allocations and selection decisions over the next two years. Bringing the finance function's understanding of data controls and processes and the audit committee's related oversight to bear on climate and other ESG reporting is essential to establishing the investment-grade quality data that investors seek.

As companies consider refining or adding new ESG disclosures to their SEC filings in response to increasing stakeholder focus, and as they prepare for expected SEC rulemaking on disclosures about climate change and other ESG matters, audit committees may want to probe management on the following:

- Where does the information (e.g., data) supporting the disclosure reside?
- Is such information prepared internally or externally? If it is prepared internally, is it centrally located, or does it need to be compiled from various locations manually?
- What disclosure controls and procedures (DCPs), if any, currently exist for the information? What additional DCPs would be needed to meet the SEC requirements?
- What controls are necessary to make sure that any metrics are calculated consistently or that any changes to the methodology are disclosed?
- What processes need to be put in place to make sure that the new information can be added to a filing without compromising timelines?
- Who should participate in a cross-functional team (e.g., external reporting, legal, investor relations) to review the disclosures and close any gaps?

Additionally, audit committees should understand whether the company's disclosures and commitments concerning climate change and other ESG matters have material accounting and financial statement implications. Audit committees should be prepared for growing investor scrutiny of how climate risk is integrated into their financial statements. Some institutional investors are engaging companies about whether accounting practices and disclosures reflect the impact of climate change and the energy transition. These investors may include related expectations in their proxy voting decisions regarding auditor ratification and the election of audit committee members. The Center for Audit Quality recently issued a report, Audited financial statements and climate-related considerations, which may help audit committees better understand how climate-related risk considerations intersect with audited financial statements, including guidance on current climate-related reporting and auditing requirements in the US.

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SOX 404 disclosure trends

Audit Analytics recently released "SOX 404 Disclosures: A Seventeen-Year Review," which summarizes the trends in SOX 404 disclosures. The number of adverse internal control over financial reporting (ICFR) auditor attestations dropped nearly 41% in 2020 vs. 2019, while the number of adverse ICFR management reports dropped nearly 5% year over year. We highlight some of the notable trends and issues included in the report below. Monitoring these and other financial-reporting-related trends may assist audit committees in focusing on the top accounting issues and maintaining high-quality financial reporting.

Auditor attestations

2020: top five internal control issues cited in adverse ICFR assessments

Issue	Percentage of disclosures	Number of disclosures
1. Material/numerous year-end adjustments	50.7%	74
2. Accounting personnel resources	42.5%	62
3. Information technology	36.3%	53
4. Inadequate disclosure controls	21.2%	31
5. Segregation of duties (personnel)	19.2%	28

Management reports

2020: top five internal control issues cited in adverse ICFR assessments

Issue	Percentage of disclosures	Number of disclosures
1. Accounting personnel resources	74.6%	991
2. Segregation of duties (personnel)	63.2%	840
3. Inadequate disclosure controls	25.4%	337
4. Insufficient audit committee	20.9%	278
5. Material/numerous year-end adjustments	20.7%	275

Auditor attestations

2020: top five accounting issues cited in adverse ICFR assessments

Issue	Percentage of disclosures	Number of disclosures
1. Revenue recognition	28.1%	41
2. Tax expense	13.0%	19
3. Liabilities	11.6%	17
4. PPE, intangible or fixed assets	11.0%	16
5. Inventory	10.3%	15

Management reports

2020: top five accounting issues cited in adverse ICFR assessments

Issue	Percentage of disclosures	Number of disclosures
1. Debts and warrants	8.1%	108
2. Revenue recognition	7.2%	96
3. Accounts receivable, investments and cash	6.6%	88
4. Subsidiary/affiliate issues	5.3%	71
5. Liabilities	5.3%	70

Additional resources

- SEC Reporting Update – Highlights of trends in 2021 SEC comment letters
- Technical Line, *Revisiting the SEC's guidance on climate change disclosures in today's environment*

3

Tax and other policy-related developments

The tax landscape is in flux. Multinational companies are navigating a range of policy shifts, including potential major US tax legislation, continuing progress on the Organisation for Economic Co-operation and Development (OECD) BEPS 2.0 project and a growing focus on the role of tax in the ESG agenda.

Add in the ongoing human and economic effects of COVID-19, and the result is a challenging and dynamic tax environment for businesses. Boards and audit committees should oversee their organizations' preparedness for and responses to these issues, all of which could affect business models, supply chains and decisions. Businesses should consider modeling and analysis to map out future scenarios and prepare for added complexity. This increased complexity could also lead to businesses facing more tax controversy. Audit committees will want to make sure that all tax matters related to COVID-19 and the broader tax landscape have been appropriately assessed and considered.

US tax policy changes and developments

Audit committees will need to anticipate possible tax policy changes at both the federal and state levels and understand the potential business implications arising from these developments:

US tax legislation — deadlines approaching

At the time of publication, the Biden administration and US congressional Democrats were aiming to enact significant tax legislation as part of their social spending bill, the Build Back Better Act (BBBA), before year-end. The House of Representatives passed the $1.6t legislation on November 19, but changes may still be made in the Senate that could affect the size and scope of the bill and its tax elements. Earlier in November, Congress passed a $1.2t bipartisan infrastructure investment bill.

The legislative process for the BBBA has required a delicate balancing act and several rounds of changes to try to satisfy both progressive and moderate groups within the Democratic party whose support will be needed if the measure is to pass.

The BBBA and its accompanying tax increases are moving through the budget reconciliation process, which allows for passage with a simple majority in the Senate instead of the usual 60 votes. Although further modifications may be made to the $1.47t of tax increases in the bill,[2] the House-passed legislation contains the following key tax changes:

- A 15% corporate alternative minimum tax based on book income for companies with more than $1b in profits, effective January 1, 2023
- A 1% surcharge on stock buybacks, effective January 1, 2022

> Audit committees will need to anticipate possible tax policy changes at both the federal and state levels.

[2] "Distributional Effects Of The Revenue Provisions Of Title XIII – Committee On Ways And Means, Of H.R. 5376, The "Build Back Better Act," As Passed By The House Of Representatives," Joint Committee on Taxation, November 23, 2021, (JCX-47R-21).

- Complex changes to the US international tax regime that would increase taxes paid by most US multinational companies, including changes to the rules governing the foreign tax credit, the rules for computing global intangible low-taxed income and the deduction for foreign-derived intangible income, among others
- New interest deduction limitations on excessive interest for US corporations that are part of multinational financial reporting groups
- An expansion of the net investment income tax to business income of individuals with incomes greater than $400,000
- A 5% surcharge on income of greater than $10m, with an additional 3% surtax on income greater than $25m
- Modifications to the wash sale rules
- New limits on IRA contributions and Roth contributions and conversions for high-income taxpayers

The BBBA also includes $80b for the IRS to invest in "compliance, technology and taxpayer services," which could result in expanded audit capabilities in the near future.[3]

State outlook

Anytime the federal tax law changes, there will be state tax implications since most state income tax systems start with US federal taxable income. The US federal tax legislation currently being developed in Congress (notably the international tax provisions) has the potential to impact state income taxes for businesses.

Unrelated, but equally important, a growing number of states are also enacting pass-through entity (PTE) taxes. These PTE taxes, which states have employed as a "workaround" to the Tax Cuts and Jobs Act's federal state and local tax deduction limitation, differ from state to state, creating complexities for owners of businesses with multistate activities. States are also on the forefront of taxing the digital economy, employing new taxes on digital advertising services, expanding sales and use tax bases to include digital goods, streaming services and platform companies and targeting new areas such as non-fungible tokens and cryptocurrencies for taxation.

Further, in response to COVID-19, businesses are adopting various work from home options, including working remotely from any state and hybrid in-office/remote models. Remote workers can impact employer (as well as employee) tax responsibilities (e.g., withholding, unemployment taxes, corporate income and franchise taxes) and create taxable nexus for a business in new states and localities.

[3] "Estimated Revenue Effects of Increased Funding for the Internal Revenue Service in H.R. 5376, the Build Back Better Act," Congressional Budget Office, November, 18 2021. The CBO estimates that the funding for tax enforcement activities would increase outlays by $80b and revenues by $207b, decreasing the deficit by $127b through 2031.

Other policy and global developments

Audit committees should continue to monitor the new tax policies, regulations and other developments beyond the US.

Tax reform on a global scale

Outside the US, many other countries are also moving ahead with their own tax reforms.[4] Presently, 136 countries have agreed to a two-pillar set of global corporate tax changes being developed through the OECD/G20 Inclusive Framework that would reframe the long-standing international tax architecture. Known as "BEPS 2.0," the OECD proposals involve a new global minimum tax framework at a 15% rate and revisions to existing nexus and profit allocation standards, which could significantly alter where a company's income is taxed.

There is still much technical work to be completed on the substantive details of the new rules — some rules are expected to be released by year-end, while others are planned for release in 2022. The timeline remains ambitious, with most provisions targeted to take effect in 2023. As the remaining details are filled in, attention will focus on country-level activity to implement the agreed rules through domestic legislation and bilateral and multilateral tax agreements.

Because these changes may result in higher taxes for multinational companies, it will be important for boards to monitor the details and implementation action by countries. This is also the time to consider providing feedback to country policymakers as the rules are being implemented.

The environment — another global tax issue

Governments are introducing business incentives and penalties in their drive toward sustainability. Recently, at COP26, nearly 200 countries signed the Glasgow Climate Pact, the key summit agreement which sets out the actions and commitments that each country will follow to limit global warming to 1.5°C above pre-industrial levels. The collective activity across governments and the private sector during the conference demonstrates that environmental sustainability and ESG continue to be top issues, thus boards and audit committees need to be aware of the risks and opportunities that could affect their businesses.

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[4] For example, in September, Colombia enacted tax reform legislation that included an increase in the corporate income tax to 35% beginning in 2022. Argentina has upcoming elections that may also lead to possible changes in tax policy, and there has been proposed tax reform in Brazil. See the EY Americas tax policy update, October 8, 2021.

Recent and past US climate mitigation proposals have included carbon border taxes, border adjustment mechanisms and carbon taxes. The BBBA includes green energy tax incentives, non-tax investments in clean energy and natural resources protections.

Increasingly tax intersects with ESG matters, particularly around a company's approach to taxation: its carbon footprint and climate mitigation strategies, its decisions around using available tax incentives and credits and its overall tax transparency and reporting. Tax is often used as a lever to drive (and fund) economic and policy change, and a company's decisions around tax engagement, tax incentives and tax disclosures have implications for its ESG strategies. Varied and vast ESG reporting metrics can mean that a company may report different facts and figures to different groups, which can increase its tax and reputational risk.

Trade issues

US trade policy under the Biden administration has been focused on addressing existing bilateral issues and supporting broader administration concerns with China, supply chain resiliency and ESG matters. On October 31, the United States and the EU unveiled an interim trade arrangement that will suspend US punitive duties on EU-origin steel and aluminum imposed during the Trump administration, instead implementing a tariff-rate quota that goes into effect in January. The EU, in turn, will suspend current 25% tariffs levied on certain US products imported into the EU and forgo any planned tariff increases. The Biden administration has, for the most part, retained policies adopted during the Trump administration, particularly for China. The overall emphasis on a "worker-centric" trade policy has, in practice, resulted in a continuation of the more protectionist policies of the prior administration.

A significant development across the major trading blocs (US, EU and China) is the emphasis on supply chain resiliency and government efforts to promote stronger, more diversified domestic production of key strategic products.[5] Trade policies are being pursued that actively support these efforts.

Regionalization is expected to continue in response to supply chain pressures driven by the pandemic and the aforementioned trade policies. The trading system's emerging architecture reflects this as the multilateral-based World Trade Organization (WTO) continues to face challenges, and jurisdictions like the UK, mainland China and Taiwan express interest in regional agreements like the Comprehensive and Progressive Trans-Pacific Partnership (CPTPP).

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[5] In the US, an Executive Order supply chain report with numerous executive and legislative recommendations was published with the intent of driving a national supply chain strategy. The EU is pursuing its own "open strategic autonomy," and China has its "dual circulation" policy, all of which are designed to drive policies that enhance domestic production of key products.

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Regulatory developments

SEC Chairman Gary Gensler continues to focus on company disclosures and investor protection. Given his priorities and the changing regulatory landscape, audit committees and SEC registrants should keep abreast of the evolving SEC agenda and the impact that such changes have on the organization.

SEC's regulatory agenda

Chair Gensler's priorities have been reflected in the SEC's semiannual regulatory agenda that lists the short- and long-term regulatory actions it plans to take. Key SEC rulemaking areas include special purpose acquisition company mergers, disclosures about climate-related and other ESG matters (e.g., board diversity, human capital), and cybersecurity risk governance.

The SEC is also reconsidering certain proxy-related rules. For example, the SEC's DCF issued Staff Legal Bulletin 14L, *Shareholder Proposals*, setting forth its views on the application of Rule 14a-8 of the Securities Exchange Act, which allows companies to exclude shareholder proposals from their proxy statements in certain circumstances. In addition, the SEC recently adopted amendments to its rules that require the use of universal proxy cards in all nonexempt solicitations involving contested elections of directors. Companies will need to comply with the amended rules for a shareholder meeting involving a contested director election after August 31, 2022. The SEC also proposed changes to rescind two conditions it added in 2020 to its proxy solicitation rules on exemptions that proxy voting advice businesses typically rely on to avoid the information and filing requirements (i.e., Securities Exchange Act of 1934 Rules 14a-2(b)(1) and (b)(3)).

It also plans to address unfinished rulemaking mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, including finalizing pay vs. performance rules and clawback policies. In October 2021, the SEC requested public comments on its 2015 clawback proposal that would direct national securities exchanges to establish listing standards that would require companies to develop and implement policies to recover incentive-based compensation after an accounting restatement.

In addition, the SEC will continue to focus on investor protection issues related to developments in China regarding Chinese companies that are trading in the US. The SEC and the Public Company Accounting Oversight Board (PCAOB or the Board) also are expected to advance implementation of the Holding Foreign Companies Accountable Act (HFCAA), which sets out requirements for foreign companies that trade in the US but whose auditors cannot be inspected or investigated by the PCAOB because of a local law or regulation. It also will block trading of the securities of these companies in the US after three years. Currently, the HFCAA is expected to impact clients of PCAOB-registered firms in mainland China and Hong Kong.

Chair Gensler also issued a statement calling for China-based companies seeking to register securities to disclose (1) whether the operating company or the shell company was denied permission from Chinese authorities to sell shares on US exchanges and (2) the potential for future delisting under the HFCAA if the PCAOB is unable to inspect the issuer's public accounting firm.

Chair Gensler and senior SEC staff also have laid out their approach to enforcement, emphasizing the need to restore trust in the public capital markets. One area of focus is holding market participants accountable as appropriate for not living up to their obligations. This includes gatekeepers such as lawyers, accountants and directors, all of whom the SEC views as the first line of defense against wrongdoing. To reinforce this accountability, the SEC Division of Enforcement expects to use tools such as admissions of wrongdoing in order to reach settlements with defendants, where appropriate. Senior SEC staff also have highlighted the importance of auditor independence and the shared responsibility of the auditor, management and audit committee in protecting it.

Given the dynamic regulatory environment, audit committees should continue to monitor information from the SEC and other regulatory authorities, including how the potential rulemaking may impact reporting requirements and related disclosures.

"Key SEC rulemaking areas include special purpose acquisition company mergers, disclosures about climate-related and other ESG matters (e.g., board diversity, human capital), and cybersecurity risk governance.

SEC approves new Nasdaq listing rules on board diversity

The SEC approved rules proposed by the Nasdaq Stock Market LLC requiring all listed companies to meet certain minimum diversity targets or disclose why they aren't doing so.

Most Nasdaq-listed companies will be required to have, or explain why they do not have, at least two diverse board members, including one director who self-identifies as female and one director who self-identifies as either an underrepresented minority or lesbian, gay, bisexual, transgender, queer or other (LGBTQ+). All listed companies must also provide statistical information about the diversity of their boards by the later of August 6, 2022, or the filing date of their proxy statement or information statement for their annual shareholders' meeting (or the date they file their Form 10-K or Form 20-F if they do not file a proxy or information statement) in 2022. Under the rule's transition provision, all listed companies must have one diverse director (or explain why they don't) by the later of August 6, 2023, or the date they file their proxy statement or their information statement for their annual shareholders' meeting (or the date they file their Form 10-K or Form 20-F if they do not file a proxy or information statement) in 2023.

Companies and audit committees should evaluate implications and reporting considerations relating to the above.

Mandatory compliance date for recent SEC amendments to Regulation S-K

As a reminder, the SEC's November 19, 2020, amendments to Regulation S-K Items 303, MD&A, will be mandatory for fiscal year ending on or after August 9, 2021 (e.g., effective for an annual report for a year ending on September 30, 2021).

The amendments add objectives to the requirements for MD&A and change or clarify the requirements for a number of items such as liquidity and capital resources, known trends and uncertainties, critical accounting estimates and off-balance sheet arrangements.

Registrants with off-calendar year-end dates should be mindful of the effective dates and prepare for timely compliance of the amended rules. Key considerations for audit committees may include the following:

- Evaluate whether sufficient disclosures, both quantitative and qualitative, have been provided to help investors understand the impact of estimation uncertainty on a registrant's financial condition or operating results. To the extent material and reasonably available, such disclosure must include how much any critical accounting estimate has changed over a relevant period and a sensitivity analysis.
- Review the discussion of a company's liquidity and capital resource and assess whether it includes descriptions of material cash requirements, their general purpose and the anticipated source of the funds needed to satisfy them. It also should assess whether sufficient discussions have been included to avoid a material loss of information for investors if the company chooses to eliminate the contractual obligation table.
- If the company chooses to remove selected quarterly financial data table, assess whether such removal is appropriate (e.g., whether there has been a material retrospective change affecting comprehensive income).

> "Most Nasdaq-listed companies will be required to have, or explain why they do not have, at least two diverse board members.

PCAOB outlook and developments

The SEC appointed a new Chair and three other new Board Members to the PCAOB in November: Erica Williams as Chairperson and Christina Ho, Kara Stein and Anthony (Tony) Thompson as Board members. Acting PCAOB Chair Duane DesParte will continue his service as a board member and will remain in his acting chair role until Williams is sworn in. Audit committees, external auditors and SEC registrants should keep abreast of the new Board's strategic priorities and standard setting agenda as it develops in the coming months and the impact that such changes can have on the execution of audits and overall audit quality.

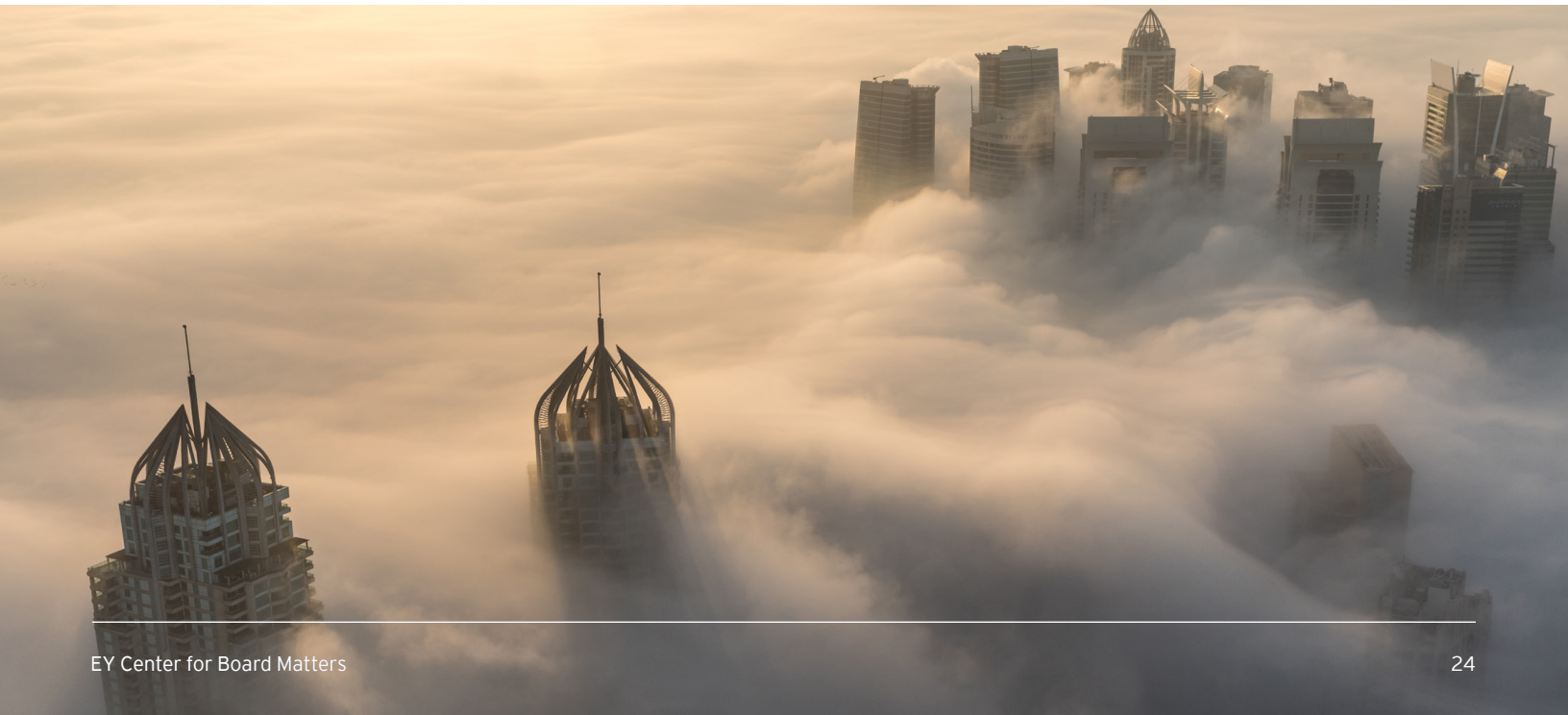
The PCAOB's inspection findings, enforcement matters and areas of inspection focus should be considered by registrants, external auditors and the audit committee. In October 2021, the PCAOB issued its *Staff Update and Preview of 2020 Inspection Observations*,[6] highlighting both good practices observed during audit inspections and areas of recurring deficiencies. Consistent with prior years, some of the recurring deficiencies were in the areas of assessing risks of material misstatement relating to revenue and related accounting, estimates, inventory, critical audit matters, Form AP, and ICFR. Audit committees may find the observations useful as they engage with auditors.

"Audit committees, external auditors and SEC registrants should keep abreast of the new Board's strategic priorities and standard setting agenda as it develops in the coming months and the impact that such changes can have on the execution of audits and overall audit quality.

[6] "PCAOB spotlight: Staff update and preview of 2020 inspection observations," Public Company Accounting and Oversight Board, October 2021.

Additional resources

- To-the-point — SEC eliminates certain MD&A requirements and revises others to make disclosures more useful



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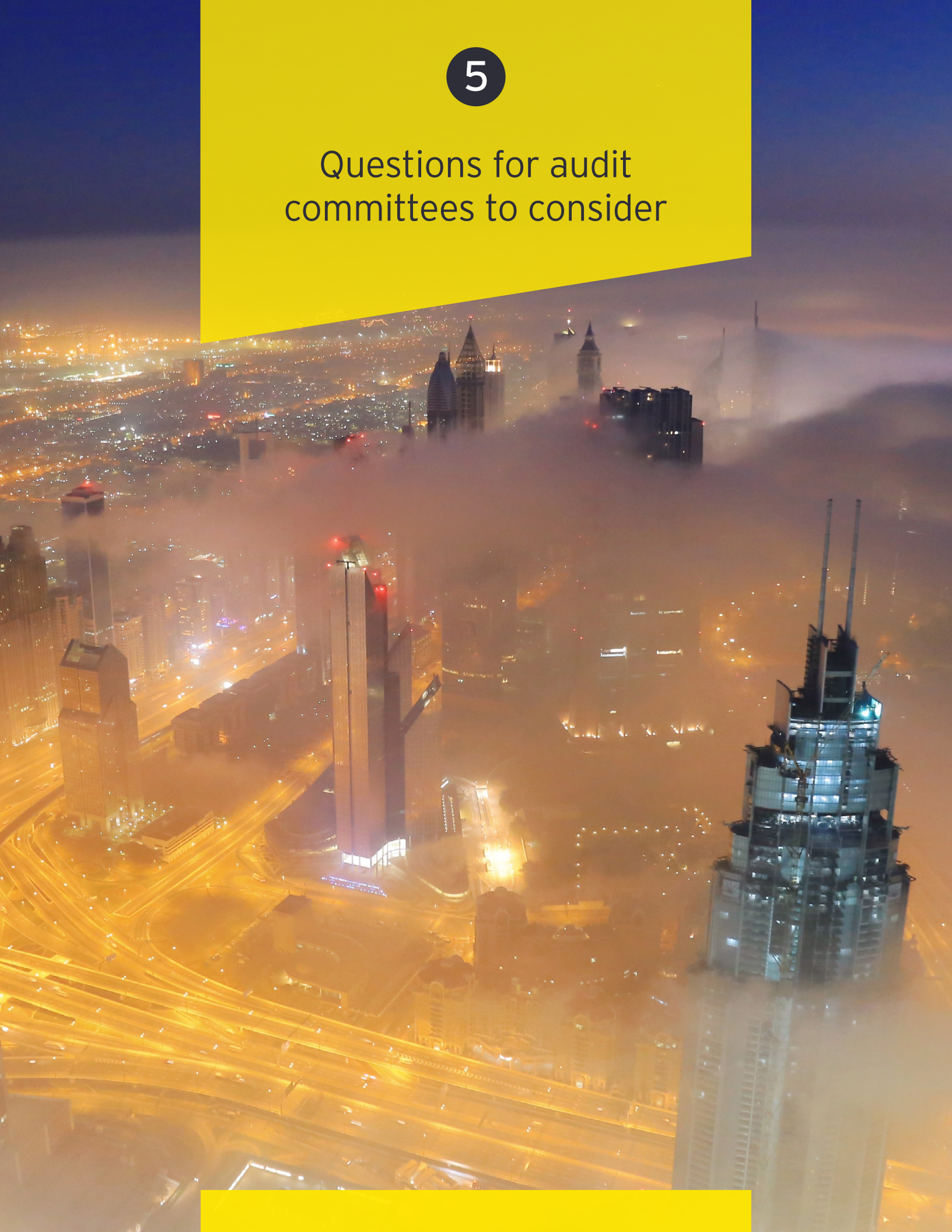
Questions for audit committees to consider



Risk management

- How is the company using new technologies and data to enhance stress testing and scenario analyses to better anticipate surprises and significant variability in operating performance?
- Do scenario analyses consider an appropriate range of extreme and even improbable scenarios, including existential threats? Do they incorporate the potential compounding effects of various risks?
- How can the organization build resiliency while remaining lean and agile enough to respond to unforeseen risks? Are contingency and response plans related to risks, including cybersecurity and supply chain, periodically simulated and reviewed with the board?
- How is the company revisiting and adapting its risk management strategy and management's approach to the three lines model in response to potential changes in the external and internal environment, changes in strategy and risk landscape and the company's operating model?
- How is the company managing critical third-party and systemic risks, including those related to financial and operational resiliency, IT security, data privacy, and the company's supply chain?
- Has the board considered how the organization's technology strategy is evolving, including how AI and other emerging technologies can be used to review and validate data and information to unearth insights into enterprise risks and opportunities?
- Have the company's information security measures and other controls been reviewed and adapted to be responsive to ongoing digital acceleration efforts, technology changes and the shifting business environment?
- How has the company's cybersecurity risk management program evolved to address the post-pandemic context, in which attackers are targeting a larger surface area and using increasingly unpredictable tactics? How is cybersecurity proactively integrated into all major strategy or tactical decisions, such as transactions, alliances, new products or services, and technology upgrades?

Financial reporting

- Has management assessed whether the company's current disclosures on climate-related matters consider the SEC's 2010 guidance?
- Does the company have sufficient controls and procedures over nonfinancial data? Is IA providing any type of audit coverage on ESG-related data 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, sustainability report), is there consistency in the disclosures? Has the company evaluated controls related to such disclosures?
- How is the organization proactively assessing opportunities to enhance stakeholder communications, including corporate reporting, to address changes in operations and strategies as well as changing stakeholder expectations?
- 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 or processes that are key in internal controls over financial reporting? If so, has management identified mitigating controls to address any potential gaps?
- External auditors: were there material changes to materiality assessments, scope, physical inventory counts and the overall planned audit approach? Were there any "close calls" or areas that were particularly challenging as a result of the current environment and remote workforce? What additional procedures has the external auditor performed to gain comfort regarding key assumptions, estimates and prospective financial information? How has the engagement team considered the potential increase in errors due to work-from-home distractions or changes to the incentive, opportunity and rationalization of the fraud triangle? Has there been a reevaluation of critical audit matters and how will auditor reporting requirements be impacted?

Tax

- Did the organization use any COVID-19-related tax benefits in 2021? How were those benefits identified and documented?
- Has the organization reviewed its approach to tax controversy management in light of the ongoing pandemic and the shifting economic, trade and tax policy environment?
- What systems are in place to keep the organization informed of tax policy changes and related developments?
- Has the company performed modeling and scenario planning reflecting potential tax policy changes and trade developments?
- What role does tax play in the organization's ESG strategy?

Regulatory developments

- In anticipation of SEC rulemaking on disclosure of ESG-related matters, what steps will be taken to evaluate and adopt processes and controls related to potential new disclosure requirements?
- What process does the committee have in place for regulatory updates and is the committee sufficiently engaged in dialogue providing views and input as needed on the related impacts?
- Does the company's proxy statement effectively communicate how the audit committee is overseeing and engaging with the external auditor? Does it address areas of investor interest, such as the independence and performance of the auditor? Has the audit committee considered how changes in the auditor reporting requirements may impact audit committee disclosures?
- In light of the changing environment, what additional voluntary proxy disclosures might be useful to shareholders related to the audit committee's time spent on certain activities, such as cybersecurity, data privacy, business continuity, corporate culture and financial statement reporting developments?

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