EY Center for Board Matters

What audit committees need to know at the end of 2019
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Introduction

In this 2019 edition of our annual review of issues affecting audit committees during the year-end audit cycle, we summarize key developments for audit committees to consider. The audit committee role grows more demanding and complex amid fast-paced change, and this report will assist audit committees as they proactively address recent and upcoming developments in financial reporting, tax, the regulatory landscape and risk management.
The Securities and Exchange Commission (SEC) staff has remained focused on ensuring financial reporting and disclosure reflect a changing business environment. Revenue recognition was the most frequent area of comment. This is consistently an area receiving significant comment which was anticipated this year as a result of the adoption of the Accounting Standards Codification (ASC) 606 (Revenue from contracts with customers). Revenue recognition comments were primarily focused on:

- Identifying performance obligations
- Determining whether a registrant is the principal or an agent in a revenue transaction
- Estimating variable consideration
- Meeting the criteria for using the residual approach for estimating selling prices
- Proper disaggregation of revenue in the notes to the financial statements

The financial reporting system involves many stakeholders playing different but interconnected roles in a process designed to address the financial disclosure needs of investors. The strength of our financial reporting structure relies on the rigor of all parts of this system.

Sagar Teotia
Chief Accountant at the SEC
The chart below, based on our research, summarizes the top 10 most frequent areas of comment from SEC staff this and last year.

<table>
<thead>
<tr>
<th>Comment area</th>
<th>Ranking 12 months ended 30 June</th>
<th>Comment as of % total registrants that received comment letters</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue recognition</td>
<td>1</td>
<td>23%</td>
</tr>
<tr>
<td>Non-GAAP financial measures</td>
<td>2</td>
<td>35%</td>
</tr>
<tr>
<td>Management’s discussion and analysis (MD&amp;A)**</td>
<td>3</td>
<td>33%</td>
</tr>
<tr>
<td>Fair value measurements***</td>
<td>4</td>
<td>14%</td>
</tr>
<tr>
<td>Intangible assets and goodwill</td>
<td>5</td>
<td>10%</td>
</tr>
<tr>
<td>Income taxes</td>
<td>6</td>
<td>10%</td>
</tr>
<tr>
<td>Activities in countries designated as state sponsors of terrorism</td>
<td>7</td>
<td>11%</td>
</tr>
<tr>
<td>Segment reporting</td>
<td>8</td>
<td>11%</td>
</tr>
<tr>
<td>Acquisitions and business combinations</td>
<td>9</td>
<td>7%</td>
</tr>
<tr>
<td>Signatures/exhibits/agreements</td>
<td>10****</td>
<td>5%</td>
</tr>
</tbody>
</table>

The SEC staff are also reviewing disclosures related to the LIBOR transition, Brexit and non-GAAP financial measures. There has been some discussion around quarterly reporting, but there are no planned changes to requirements.

On accounting standards, the Financial Accounting Standards Board (FASB) is conducting engagement on the implementation of ASC 842, Leases, and the current expected credit losses (CECL) Accounting Standards Update. In October 2019, the FASB confirmed that it will defer the effective dates for major new accounting standards that have not yet been adopted by privately held companies: leases, hedging and CECL standards. Private companies will have to adopt the leases and hedging standards in 2021 and the CECL standard in 2023. The SEC has also proposed changing disclosure requirements for acquisitions and disposals of businesses, and the FASB has issued final guidance that will significantly change how insurers account for long-duration contracts.

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* These rankings are based on topics assigned by research firm Audit Analytics for SEC comment letters issued to registrants about Forms 10-K from 1 July 2017 through 30 June 2019. 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 (20%), (2) critical accounting policies and estimates (10%), (3) liquidity matters (8%), (4) business overview (6%) and (5) contractual obligations (2%). Many companies received MD&A comments in more than one category.

*** This category includes SEC staff comments on fair value measurements under ASC 820, Fair Value Measurement, as well as fair value estimates, such as those related to revenue recognition, stock compensation and goodwill impairment analyses.

**** This topic was not among the top 10 in 2018.
Focus on LIBOR, Brexit and non-GAAP disclosures

The staff of the Office of the Chief Accountant have indicated that the transition from LIBOR could have a significant effect on an issuer’s accounting and financial reporting. Areas the staff highlighted include modifications of the terms of debt instruments, hedging activities, inputs used in valuation models and potential income tax consequences. With the expected discontinuation of LIBOR, the SEC staff has started to review disclosures to assess the transparency of the risks associated with the transition (e.g., whether registrants describe the types of backstop arrangements that may be in place if LIBOR is no longer quoted). The transition could trigger disclosures in, for example: risk factors, management’s discussion and analysis, board risk oversight sections and financial statements. In each of these cases, the disclosures should evolve as companies learn more about the likelihood and materiality of the effects. The SEC staff has noted that LIBOR transition disclosures may be more material for companies in the real estate, banking and insurance industries. However, all companies are advised to plan for the transition and consider relevant disclosures. Disclosures should address company efforts to evaluate and mitigate risks associated with discontinuation of LIBOR and information used by management and the board in monitoring how the LIBOR transition may affect the company.

The FASB proposed providing temporary optional expedients and exceptions to the US GAAP guidance on contract modifications and hedge accounting in light of the expected market transition from LIBOR to the Secured Overnight Financing Rate (SOFR). This transition relief would significantly ease the transition requirements for many companies. A final standard is expected in early 2020.

The SEC staff has also said it will focus on disclosures of company-specific risks associated with Brexit. The SEC staff expect companies to expand disclosures about the potential effects of Brexit, where material. This may include describing implications to foreign operations affected by Brexit, and issuers should consider:

- Changes to disclosed risk factors or new risk factors (such as supply chain risks due to the lack of free trade agreements, possible loss of customers, decreases in revenues or increases in costs resulting from changes in exchange rates or tariffs, exposure to new regulatory risks, etc.)
- Disclosing forward-looking information about reasonably likely effects on matters such as income taxes, financing and operations
- Additional quantitative and qualitative disclosures to describe uncertainty associated with fair value estimates related to impairment of investments, goodwill and other assets
- Impacts on financial statements (e.g., impairment, recognition and measurement)

The SEC continues to focus on non-GAAP financial measures in its comments to registrants. In particular, the SEC has focused on issues around prominence of non-GAAP measures (ensuring they are less prominent than related GAAP measures), inconsistent presentation in different fiscal periods, excluding normal recurring cash operating expenses from performance measures and adjustments that reflect individually tailored GAAP recognition and measurement principles. Staff Compliance and Disclosure Interpretation 100.04, issued in 2016, provided SEC staff guidance that states non-GAAP financial measures that involve individually tailored accounting principles may be misleading and inappropriate under Regulation G. In addition, the SEC staff has also emphasized the importance of having disclosure controls and procedures to make sure non-GAAP disclosures are not misleading and are presented consistently. Audit committees can play an important role in understanding how management uses non-GAAP financial measures and how they supplement the GAAP financial statements. Audit committees that display strong interest in non-GAAP financial measures can have a positive effect on the quality of disclosures.

ASC 606 disclosures

In comment letters to registrants that have adopted the new revenue standard, the SEC staff has focused on areas of judgment such as identifying performance obligations, estimating variable consideration, recognizing revenue over time or at a point in time, analyzing principal versus agent considerations and disaggregating revenue for disclosure purposes. The SEC staff has asked registrants to further explain and sometimes provide their analysis for judgments and estimates made in their application of the standard. The SEC staff has been encouraging companies to continue refining and supplementing their revenue recognition disclosures in areas that require significant judgments or involve estimates. When making this evaluation, companies should consider disclosures by peer companies, industry practice and other leading practices as they evolve. The volume of comments
related to revenue recognition nearly doubled the year ended 30 June 2019, and represented about one third of all comments. Overall, this was not unexpected because revenue is frequently an area of comment, and the implementation of a new standard is typically an SEC staff focus area.

ASC 842, Leases

Entities that have adopted the new leases standard need to make sure that they have policies, processes and controls in place to account for new or modified leases and those that must be reassessed or remeasured under ASC 842. A critical step in accounting for new, modified or reassessed lease contracts is to determine the appropriate lease term and the inputs used to estimate the incremental borrowing rate. Lessors that have adopted the new leases standard will need to monitor the collectability of lease payments (and any amounts necessary to satisfy a residual value guarantee) both at and after the lease commencement date. During the implementation many companies used manual workarounds for new or modified systems when they implemented the leases standard. As companies continue to modify their systems, processes and procedures, they need to consider whether they are required to disclose changes in internal control over financial reporting (ICFR) during the latest quarter that have materially affected or are reasonably likely to materially affect an entity’s ICFR.

Current expected credit losses (CECL)

The new credit losses standard affects entities in all industries, not just those in financial services, and makes significant changes to the accounting and disclosures for credit losses on a wide variety of financial instruments, including loans, reinsurance and trade receivables. Entities should consider whether they need to create or enhance their processes and controls over key judgments to comply with the new current expected credit losses model. Also, entities are now required to recognize an allowance for expected credit losses for short-term accounts receivable, even those that are current. Therefore, changes to processes and controls over accounting for determining the allowance for short-term accounts receivable may be necessary to meet the objectives of the new standard. As part of management’s certification of an entity’s ICFR in its periodic report, SEC registrants must disclose changes in ICFR during the latest quarter that have materially affected or are reasonably likely to materially affect an entity’s ICFR. SEC registrants should also consider whether to disclose any changes they made to their controls to implement the new standard.

SEC proposes changing disclosure requirements for acquisitions and disposals of businesses

In an environment in which 83% of executives expect the US mergers and acquisitions environment to improve in the next 12 months, it is important to be aware of SEC-proposed changes to the significance tests registrants perform to determine whether to provide financial statements of businesses they acquire and pro forma information for those transactions. Registrants would consider their market capitalization, rather than total assets, in the investment test and both their revenue and after-tax income in the income test, rather than only pretax income. In addition, the proposal would formalize existing practice on providing abbreviated financial statements of acquired businesses in certain circumstances. The proposal also would eliminate any requirement to provide three years of financial statements for an acquired business or a probable acquisition. We expect that this change will reduce the risk that a desired acquisition will cause SEC compliance issues.

The pro forma financial information requirements would focus not only on the purchase accounting performed under US GAAP or IFRS, but also management’s expectations for synergies and other plans that are reasonably estimable and reasonably expected to occur. The preparation of pro forma financial information may become more challenging under the proposed rule due to the subjective nature of adjustments for these synergies and post-combination plants. The significance threshold for reporting a registrant’s disposal of a business and related pro forma information would increase to 20% from 10%. Finally, the proposal would change requirements for investment, real estate, and oil and gas companies.

The significance threshold for reporting a registrant’s disposal of a business and related pro forma information would increase to 20% from 10%.

Ernst & Young LLP, Why US executives are focused on sustainable M&A business strategy in uncertain markets, October 2019.
Financial reporting

Questions for the audit committee to consider

1. Has the audit committee played a role in understanding how management may be using non-GAAP financial measures to supplement GAAP financial statements and the appropriateness of disclosure controls? Why does management believe the non-GAAP measures provide meaningful and useful information to investors?

2. What is the company’s plan for transitioning from LIBOR to SOFR, and has the company considered what disclosures to provide to investors?

3. Is the audit committee sufficiently focused on the potential company-specific risks associated with Brexit such that appropriate updates to reporting and disclosure can be made?

4. What changes to internal control over financial reporting have been implemented, and what key actions have been taken by management to implement new ASUs and ASCs?

5. Has the company’s management sufficiently challenged the adequacy of its disclosures required under new accounting standards, particularly in areas that require significant judgment or estimates?

Addressing short-termism in the market

A request for comment on requirements regarding the nature, timing and frequency of interim reporting closed at the end of March; however, the SEC has encouraged continued submissions. The SEC also hosted a roundtable in July on the effect of short-termism on US capital markets to encourage further discussion. Comments and feedback from the investor community strongly support continued quarterly reporting; however, there does seem to be broad support for the FASB and SEC to consider ways to streamline interim disclosure requirements.

SEC Chairman Clayton has stated on several occasions that he does not expect the frequency of interim reporting to change for large public companies in the near future. We support quarterly reporting because it gives investors access to timely and decision-useful information, but we believe there are opportunities for the SEC and the FASB to reduce the cost and burden of providing that information (e.g., less prescriptive quarterly reporting requirements, focus on material changes in the quarter).

Additional reference

- Sagar Teotia Remarks before the AICPA National Conference on Banks and Savings Institutions
- Request for Comment on Earnings Releases and Quarterly Reports
- To the Point – SEC seeks input on earnings releases and quarterly reports
- Lease accounting – Accounting Standards Codification 842, Leases
- Credit impairment for short-term receivables under ASC 326
- FASB changes how insurers measure and disclose liabilities for long-duration insurance contracts
Global tax initiatives, evolving interpretations of US tax reform legislation and ongoing trade volatility all continue to contribute to an unpredictable tax landscape for businesses. The upcoming US presidential election introduces even more layers of uncertainty about the future direction of tax policy.

Boards and audit committees are tasked with overseeing businesses’ responses to these and other considerations and making sure their organizations are able to respond rapidly to disruption in the tax space. Adapting and excelling in this environment require a greater focus on risk and compliance oversight, as well as greater involvement in monitoring policy developments and modeling different potential scenarios.

Based on our review of Form 10-K and amended 10-K filings submitted during the years ended December 31, 2018 and 2017, issues related to income taxes and deferred taxes were in the top three areas requiring financial restatement, so it is important for boards and audit committees to remain focused on developments in this area.³

³ Based on a survey of Form 10-K and 10-K/A filings submitted during the years ended December 31, 2018 and 2017, by companies audited by one of the Big Four accounting firms.
Tax

Further discussion

Tax Cuts and Jobs Act (TCJA)

Nearly two years after its enactment, the TCJA continues to be a major driver of tax planning and source of uncertainty for business taxpayers. Changes to the international tax system have required businesses to revisit their structures, supply chains and overall tax planning. Regulatory guidance related to the TCJA is still being drafted, with several important final rules packages related to international tax provisions expected before year-end. This expected guidance may provide opportunities as taxpayers plan for the future. Forms and systems necessary to file tax returns are also still being finalized, increasing compliance burdens and the potential for errors. In addition, each US state is working through the expected impact of TCJA. As a result, state taxation is more complex than ever before. While some states quickly adopt federal tax changes, others adopt much more slowly, and still others may enact state-specific legislation to account for the impact the TCJA had on income taxes in their jurisdiction.

The eventual finalization of the rules could lead to changes in financial statement tax provisions, uncertain tax position disclosures on future tax returns and amended returns. These developments could result in tax controversies related to post-TCJA tax return years, making it important for companies to thoroughly document their tax return positions while the law remains in transition — and for boards to understand what management is doing to address this need.

Boards and audit committees should understand any tax planning changes their companies have made in the wake of the TCJA and whether any additional uncertain tax positions and audit risks have been identified.

Legislative outlook

There is a desire among key tax writers of both political parties to make targeted technical fixes to the TCJA. Separately, there are efforts to craft legislation to extend several tax provisions that have expired or are expiring. It is unclear, however, if consensus can be reached or whether a legislative vehicle will be available to advance these two significant tax policy priorities.

So far, House and Senate tax writers have taken different approaches to the “tax extenders,” and a compromise has yet to emerge. Several tax provisions are also due to expire at the end of 2019, which could cause last-minute year-end tax provision and compliance challenges for multinational taxpayers.

Deadlines often propel congressional action, and some of these tax efforts may be paired with legislation such as appropriations bills that need to be passed to keep government agencies open. However, the House’s impeachment inquiry may make it more challenging for lawmakers to make progress on tax and other legislative priorities, slowing progress and causing greater uncertainty.

Trade policy

The US trade environment remains volatile and challenging from a business planning perspective and will likely continue to have repercussions for the global economy. The United States and China have imposed or plan to impose significant tariffs on nearly all imported products, as well as other non-tariff barriers, and it is unclear whether planned trade negotiations between the two countries will prove successful.

Boards and audit committees should understand any tax planning changes their companies have made in the wake of the TCJA and whether any additional uncertain tax positions and audit examination risks have been identified.
From a legislative standpoint, the administration continues to push for congressional ratification of the United States-Mexico-Canada Agreement (USMCA), the revised North American Free Trade Agreement (NAFTA). A vote later this year in Congress remains possible, assuming the administration and House Democrats can resolve a few outstanding concerns with the trade agreement, but the broader political environment could derail the effort. If the USMCA does not advance in Congress, the president has threatened to withdraw the United States from NAFTA.

Given the huge potential implications of global trade shifts for supply chains and prices, boards will need to stay on top of this fluid situation and understand management’s approach to addressing the volatility. Boards need to understand management’s approach to addressing this and other potential geopolitical and regulatory developments, including impacts on strategy and risk management. Companies and boards should consider the broader risk and operational impacts of tariffs and changes in trade policy, such as the implications of an undiversified supply chain, potential changes to the organization’s cost structure and operational inefficiencies. Scenario analysis and stress testing critical assumptions can assist boards in better understanding management’s process for mitigating the risks associated with an uncertain trade environment.

Global tax changes in the digital economy

The European Union and individual European countries have been examining digital services taxes (DSTs) and other new forms of taxation. Despite US government opposition, countries are moving forward with DST legislation and several countries are expected to have DSTs in place by year-end. With these efforts as a backdrop, the Organisation for Economic Co-operation and Development (OECD) has undertaken a project to address digital tax challenges in a globally coordinated way. The OECD effort has implications for all multinationals—not just digital businesses.

The OECD project would propose changes to long-standing nexus and profit allocation rules and introduction of new global minimum tax rules. The timeline is aggressive, with a goal of a conceptual agreement by the end of 2019 and full consensus on details of the new rules by the end of 2020. This timeline is largely driven by a desire to avert or replace countries’ unilateral DSTs with globally coordinated rules. This only puts more pressure on transfer pricing arrangements globally. There are 135 countries participating in this project so these developments will have implications for existing transfer pricing arrangements and general tax planning around the world.

These efforts reflect another source of uncertainty as the initiative could modify long-standing global international tax standards and practices. In the meantime, companies are struggling to assess the implications of the enacted and proposed DSTs on their income tax provisions and/or above the line taxes in their financial statements. Boards and audit committees should make efforts to understand their company’s tax strategy and digital aspirations to determine the implications of these potential new rules.

2020 and beyond

If a Democrat wins the presidency in 2020 (and depending on the political composition of the House and Senate post-election), US tax policy could move in a different direction. Dominant themes among the Democratic candidates include revisiting the TCJA, increasing taxes on corporations and high-net-worth individuals, and removing the preferential tax rate for capital gains. Democratic candidates have suggested they would use the revenue gained for a variety of purposes, including to fund infrastructure improvements, expand health care or provide middle-income tax relief. It is important to keep in mind that these plans reflect campaign rhetoric and positions may evolve over time, so this remains an area to monitor as the presidential election unfolds.

Tax Questions for the audit committee to consider

1. What additional investment or tax planning has the organization undertaken in response to the TCJA?
2. Have changes to ICFR been implemented and what key actions have management taken to address the TCJA?
3. What additional compliance procedures have been performed because of the TCJA, and have any additional audit risks been identified? If so, how have they been addressed?
4. Has the company engaged in modeling and scenario planning to weigh the potential impacts of tariffs and other trade policy developments?
5. Has the company considered proactive engagement with the OECD or individual countries on digital tax issues and the broader OECD project?

Additional reference

• US tax reform webpage
• Americas Tax Policy webpage
• Five Things to Know on the One-Year Anniversary of the Tax Cuts and Jobs Act
The SEC has remained focused on promoting public capital formation by reducing regulatory burdens for public companies, including smaller issuers. It is also continuing its years-long effort to modernize disclosures. In its latest incremental effort, it has proposed small changes to Regulation S-K, proposing a more principles-based approach to descriptions of business, legal proceedings and risk factor disclosures for public companies. In other areas that have become of increased importance to investors, such as human capital, the SEC began exploring expanded disclosures. The SEC has also provided guidance on proxy voting responsibilities and set the stage for regulation in this area.

The requirement for disclosure of critical audit matters (CAMs) came into force this year for large accelerated filers, and the Public Company Accounting Oversight Board (PCAOB) has been focused on monitoring implementation. The PCAOB is also undertaking changes to the inspections process, which are expected to include increasing transparency to the public.

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The historical approach of disclosing only the costs of compensation and benefits often is not enough to fully understand the value and impact of human capital on the performance and future prospects of an organization.

Jay Clayton
SEC Chairman
Regulatory developments

Further discussion

SEC proposals
In May 2019, the SEC proposed amendments to the accelerated filer and large accelerated filer definitions to exclude smaller reporting companies (SRCs) that have not yet begun to generate significant revenue. SRCs are subject to certain scaled disclosure requirements. By increasing the public float and revenue thresholds for accelerated and large accelerated filers, the amendments would expand the number of SRCs that also qualify as non-accelerated filers, which have longer filing deadlines and are exempted from the auditor attestation requirement for internal control over financial reporting (ICFR). The SEC has indicated that one reason for these amendments is to reduce compliance costs for these lower-revenue companies. In our view, independent audits of internal control over financial reporting support capital formation and investor protection and have had a positive effect on investor confidence and market stability. The SEC proposes also to raise the thresholds to exit large accelerated filer and accelerated filer reporting status to align with SRC definitions as well as limit cases where an SRC can also be an accelerated filer or large accelerated filer.

In addition, in August 2019, the SEC proposed amendments to modernize disclosure requirements found in Regulation S-K. The aim is to implement a more principles-based approach to descriptions of business, legal proceedings and risk factor disclosures for public companies as well as reduce repetition. Among other things, the proposed amendments revise the description of business disclosure requirements to include a list of disclosure topics that should be included only to the extent such disclosures would be material to an understanding of the registrant’s business, versus the current prescribed list of disclosure topics. The proposed list includes human capital resources, including any human capital measures or objectives on which management focuses in managing the business, such as measures related to the attraction, development and retention of personnel.

This is the first time the SEC has proposed requiring human capital metrics beyond headcount. The proposal is consistent with a recent recommendation from the SEC’s Investor Advisory Committee that human capital disclosure requirements should reflect the circumstances of a business and avoid a one-size-fits-all approach. The proposal includes several examples of human capital metrics that issuers could use in their disclosures. Some of these metrics were discussed in the 2018 report from the Embankment Project for Inclusive Capitalism, which identified value drivers important for sustainable and inclusive growth as well as potential metrics to assess them.

Harmonization of securities offering exemptions
The SEC is considering whether it should change the framework for securities offerings that are exempt from registration. The SEC issued a concept release seeking comments to help identify potential changes to simplify, harmonize and improve the current exempt offering framework. The SEC noted that the framework has changed significantly over time, and its complexity may be challenging to navigate for smaller and emerging companies that want to pursue exempt offerings. Chairman Clayton said the SEC’s goal is to make sure the “framework works for investors and entrepreneurs alike no matter where they are located in the United States.” Comments were due on September 24, 2019.

Proxy voting and proxy solicitation
Chairman Clayton has said that he wants the agency to prioritize rulemaking to improve the proxy voting process, which is known as proxy plumbing. On August 21, 2019, the SEC issued guidance on proxy voting responsibilities and an interpretation that proxy advice constitutes solicitation. The guidance covers upholding investment advisors’ fiduciary duty, evaluating the services of proxy advisory firms and communicating regarding any errors in proxy advisory firm analysis. Some believe that this guidance sets the stage for further regulation in this area. The SEC explained that asset managers must ensure that advice from proxy advisors is in line with clients’ interests and asked for disclosure on how recommendations are determined. Most recently, in early November 2019, the SEC issued a significant proposal for rulemaking in this area. The proposal includes providing more specificity on determining when proxy advice would be considered solicitation, requiring further disclosure on any conflicts of interest, providing companies with an opportunity to review proxy guidance reports and if requested, including
a company's comments by a hyperlink from their reports and, also further explaining when lack of disclosure in proxy advice would constitute misleading information. The proposal was approved by a 3-2 vote and will be subject to a 60-day comment period.

No-action requests
The SEC Division of Corporation Finance may now address some no-action requests orally, rather than in writing. The SEC staff still intends to issue a response letter where they believe it will add value. However, some investors and companies are concerned as there will be fewer writings to hold onto as evidence of correctness or incorrectness of their positions. There is also a concern about the heightened risk of inconsistencies. Shareholders retain the right to go to court, and there may be more instances of this with the reduction of written guidance from SEC staff.

Public Company Accounting Oversight Board (PCAOB) developments

Critical audit matters implementation
New requirements on the disclosure of critical audit matters (CAMs) in annual reports became effective for fiscal years ending on or after June 30, 2019, for large accelerated filers. For all other companies for which the requirements apply, they become effective for fiscal years beginning on or after December 15, 2020. In July 2019, the PCAOB issued staff guidance for audit committees on the implementation of new requirements on the disclosure of CAMs. The aim of CAMs is to provide enhanced information in the auditors’ report on those matters that involved especially complex judgment by the auditor. Disclosures should be specific in explaining the nature of the CAMs, how they were addressed and include a reference to relevant financial statement accounts or disclosures. The PCAOB and staff have stated that they will continue to monitor CAMs implementation and review whether further guidance is needed.

While a limited number of audit reports with CAMs have been filed to date, the average number of CAMs is two and the most frequently identified CAMs related to goodwill and intangible assets, revenue and income taxes.

Expanded communication with stakeholders
The PCAOB 2018-2022 Strategic Plan places an emphasis on improved engagement with a broad array of investors, audit committees, preparers and other stakeholders to enhance the quality of audit services. The PCAOB plans to enhance the timeliness, usefulness and clarity of PCAOB inspection reports and cultivate effective and dynamic dialogue with stakeholders. It also has indicated it will increase engagement with audit regulators around the world to share perspectives on different approaches to addressing the quality of audit services. A new deputy director of the PCAOB’s Office of External Affairs has been appointed as a direct point of contact for, and liaison to, investors, audit committees and preparers.

Consideration of inspections process changes
In addition to increased stakeholder engagement, the PCAOB 2018-2022 Strategic Plan also includes innovation as a strategic priority. This is particularly the case regarding the approach to inspections and standard setting, and the PCAOB Division of Registration and Inspections staff are currently reviewing how they plan, conduct and report on their inspections. This includes consideration of procedures to review engagement and systems of quality control, their approach to selecting engagements and areas of focus, and how results of inspections are communicated. The PCAOB also plans to make its oversight more forward-looking to consider evolving risks, environmental factors and stakeholder needs.

Regulatory developments

Questions for the audit committee to consider
1. To what extent is the audit committee considering how new areas of nonfinancial disclosure and related metrics are subject to adequate disclosure processes and controls?
2. Has the audit committee discussed how the CAMs were determined by the auditor? Has the committee discussed with management and the auditor the process that should be followed to the extent questions about CAMs are raised by stakeholders?
3. Are there any changes that need to be made to committee charters as a result of regulatory changes?
4. What process does the committee have in place for regular regulatory updates, and is the committee sufficiently engaged in dialogue providing views and input as needed on regulatory consultations?
5. Is the audit committee aware of any potential exemptions from registration with the SEC as a result of recent SEC proposals, and how this might affect capital raising?

Additional reference
• Amendments to the Accelerated Filer and Large Accelerated Filer Definitions
• Modernization of Regulation S-K Items 101, 103, and 105
• Audit Committee Resource: Critical Audit Matters
• PCAOB 2018-2022 Strategic Plan
• SEC in Focus
With disruption occurring at an increasing pace across a number of dimensions (e.g., new technologies, changing consumer preferences, new competitors), organizations are embracing new technologies to transform their business models, drive growth and improve efficiency. They are leveraging big data to drive competitive insights and entering into strategic transactions, such as mergers, acquisitions, divestitures, alliances and joint ventures, to enhance their competitive advantage. Management is also re-evaluating existing operating models to identify ways to become more agile and efficient to deliver results while responding quickly to new business challenges. All of these developments create both opportunities and challenges for risk management. Audit committees, or those committees tasked with risk management oversight (given that this varies by company and industry), must help organizations balance shifting priorities and resources to guide the organization in addressing the key risks it faces today and anticipating emerging risks. In this continually changing environment, boards and committees tasked with risk management oversight should continue to encourage their organizations to optimize risk management practices while also enhancing their own oversight of risk. We will refer to the audit committee for the remainder of this section, though the insights apply to any committee responsible for risk management oversight.

The siloed and reactive view of risk management prevalent today is no longer enough to guarantee the integrity and consistency necessary to build trust. Organizations need to adopt a proactive, future-facing and fully integrated approach to risk.

Amy Brachio
EY Global Advisory Risk & Performance Improvement Leader
A move toward optimizing enterprise risk management (ERM)

CEOs, directors and institutional investors believe unfavorable economic conditions, people issues (such as talent shortages due to technology change and failure to upskill), and national and corporate cybersecurity are the biggest risks that will most affect businesses in the next 12 months. Other risks, such as those related to innovation and talent, culture, geopolitics, the abundance (possibly overabundance) of data, privacy, environmental and social factors, and resilience (particularly in critical infrastructure) continue to weigh on and challenge organizations and their risk functions. Leading organizations are conducting enterprise-wide risk assessments capturing all categories of risk — strategic, operational (including technology), reputational, financial and compliance — on a continuous basis to help focus and re-calibrate on the key risk. Audit committees should verify that these dynamic assessments take a holistic view of risk and have a direct link to the organization’s overall strategy and ERM program. ERM programs should include both quantitative and qualitative considerations and incorporate forward-looking perspectives, such as risks associated with corporate objectives, growth strategies, new products, and environmental/social and regulatory changes.

With many businesses moving faster than ever, executing ERM at the speed of the business is a challenge across the three lines of defense. Management and audit committees expect risk functions to be more agile and run at the speed of the business and technological innovation. Risk leaders across the lines of defense are examining how technological innovation can deliver risk-related services faster and more efficiently. Digitally-enabled risk optimization tools can enable management to anticipate changes in the market and developments in the consumer context. Accordingly, audit committees are expecting the internal audit function to provide leading-class assurance by going beyond financial and compliance internal controls assurance to assessing the areas that matter most to the company and boards, including strategy, operations, outside market forces and emerging risks.

While boards generally say that ERM at their organization is effective in managing established risks, only 40% of boards are satisfied with the management of new and emerging risks. This highlights the need for organizations to enhance their ERM practices, particularly in the management of atypical and emerging risks. Better and faster integrated risk intelligence that provides timely insights on opportunities, risk exposures and external considerations can drive more risk-confident decisions at organizations and allow organizations to respond more quickly to market pivot points. However, more organizations are examining what they need to put in place to generate this competitive leverage. This paradigm change is causing audit committees and boards to reflect on the organization’s skill sets and talent needs for the future. This applies across finance, risk and compliance professionals as well as boards and audit committees themselves. It is important to consider skills across multiple risk topics (e.g., compliance and operational risk) and types of risks (e.g., cyber and resiliency). Making use of new technologies also requires strong knowledge of legal frameworks for external data hosting, audit procedures across different platforms, and internal and external data protection risks.

Leading organizations are also leveraging machine learning, artificial intelligence and other technologies to enhance their risk management efforts and provide predictive, forward-looking risk insights to management and boards. This is helping chief audit executives, chief risk officers and others to not only provide greater and deeper insight, but also to drive efficiencies. Internal audit functions are monitoring financial (e.g., control failures) and compliance risks through risk dashboards that provide continuous control monitoring and real-time assurance, enabling them to see areas of potential concern before they become an issue by recognizing correlations and patterns in data. For example, making use of automated techniques for more ongoing monitoring of emerging risks, deploying tolerance thresholds for key risk indicators and using machine learning algorithms to survey data across multiple years of history and evaluate and identify restatement risks.

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Based on the EY CEO Imperative Study and an EY survey conducted of 500 board members.
Enhancing oversight of cybersecurity

With technology disruption viewed as one of the top two strategic opportunities and a significant risk area, this also opens the door to exponential increased cyber risk. Boards and audit committees should continue to remain vigilant and enhance their oversight of this dynamic risk by:

• Setting the tone that cybersecurity is a critical business issue, as the time and effort the board spends on cybersecurity signify whether it is a priority for the company
• Confirming that the company’s new technology and business arrangements are designed with security, risk and compliance in mind from the beginning by embracing a trust-by-design philosophy
• Understanding the company’s value at risk in dollar terms
• Remaining familiar with the company’s processes to identify, assess and manage third-party and supply chain risks
• Making sure the cybersecurity risk management program is independently and appropriately assessed by a third party and that should report back to the board
• Having comprehensive knowledge of the company’s ability to respond and recover, which should include simulations and arranging protocols with third-party professionals before a crisis hits
• Having a thorough understanding of the cybersecurity incident and breach escalation process and protocols within the organization, including when the board should be notified
• Staying attuned to evolving board and committee cybersecurity oversight practices and disclosures, including asking management for a review of the company’s cybersecurity disclosures over the last two to three years with peer benchmarking

Oversight of privacy

New and emerging privacy laws, as well as increasingly acute attention to this issue by many stakeholders, are creating uncertainty and risk for organizations. While privacy has historically been treated as a legal, compliance or security risk, it is now evolving as a key component of reputational risk, foundational to consumer trust, and a critical tool for differentiation in the marketplace. As companies explore new ways to gather and use data, these risks are becoming fundamental to board discussions about strategy and risk. New legal requirements, such as the European Union’s General Data Protection Regulation, the new California Consumer Privacy Act, and the potential for additional state and federal privacy laws, are creating steep compliance challenges. In particular, as various state laws are developed and implemented across the US, audit committees will need to oversee compliance and readiness efforts related to a multitude of newly effective laws, some of which may conflict with each other.

In this environment, audit committees must understand the organization’s privacy posture, develop related competence (including how data privacy issues and new privacy laws and regulations are being addressed at the organization) and enhance monitoring efforts through data governance reporting metrics. Audit committees should also verify that management has the appropriate governance structures over data, including making the appropriate updates to systems, processes and policies. Adopting a control-based framework that spans an organization’s three lines of defense will provide a disciplined and comprehensive approach to addressing privacy risk and compliance.

Board and audit committee oversight of compliance

Increased regulation and enforcement and the adoption of new technology is changing the nature of compliance risks at organizations. As business has become more global and developing countries more prosperous, a movement has grown against the culture of corruption. Companies should remain proactive with managing anti-corruption risk and compliance with regulatory requirements, such as the Foreign Corrupt Practices Act.

Audit committees play a key role in setting the tone at the top regarding issues of integrity and verifying that organizations have effective compliance programs that promote ethical behavior above and beyond compliance with laws. While some organizations have a dedicated compliance function, others are taking a cross-functional approach to enhancing compliance efforts that includes internal audit, human resources, legal and finance. At leading organizations, the ownership of compliance and ethics is being distributed throughout the organization to the business leaders and embedded in all lines of the business.

Given the importance of compliance, some audit committees are using a variety of metrics to validate the effectiveness of their compliance program (e.g., internal hotline metrics and compliance training results) and performing external benchmarking on the effectiveness of their compliance program through formal third-party assessments on a periodic basis. There is also an increase in the use of digital compliance tools. For example, artificial intelligence can provide communications and risk alerts tailored to individuals in real time, which can be more effective than classroom or web-based trainings. These can optimize monitoring and reporting, and even the use of resources. In addition, audit committees should 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.
Risk management

Questions for the audit committee to consider

1. Has the audit committee reviewed the effectiveness of management’s risk management programs in relation to identifying both risks and opportunities?

2. How effective is the organization in adjusting its risk appetite in response to changes in the risk landscape?

3. How is the organization deploying new tools and technologies to identify patterns and correlations in company data to identify potential warning areas?

4. Does the organization have the necessary skill sets, talent and culture to effectively manage the organization’s significant risks? If not, what are the gaps, and how will those be addressed by management?

5. Has the audit committee considered the company’s total risk exposure for a cyber attack, including the financial, legal and reputational impacts? Have escalation and response plans been developed and simulations conducted?

Additional reference

- How to inspire confidence in the Transformative Age
- How boards are governing disruptive technology
- Four ways to ‘unlock’ the chief audit executive and create trust
- Five fast questions for CROs contemplating the year ahead
- How a real-time read of all risks can open new opportunities
- How to manage the evolving risks of emerging technology
- What boards are doing today to better oversee cyber risk
- What companies are sharing about cybersecurity risk and oversight
- SEC Statement and Guidance on Public Company Cybersecurity Disclosures
- Why you need a strategic approach to political risk
20 questions for audit committees to consider

Financial reporting

1. Has the audit committee played a role in understanding how management may be using non-GAAP financial measures to supplement GAAP financial statements and the appropriateness of disclosure controls?
2. What is the company’s plan for transitioning from LIBOR to SOFR, and has the company considered what disclosures to provide to investors?
3. Is the audit committee sufficiently focused on the potential company-specific risks associated with Brexit such that appropriate updates to reporting and disclosure can be made?
4. What changes to internal control over financial reporting have been implemented, and what key actions have been taken by management to implement new ASUs and ASCs?
5. Has the company’s management sufficiently challenged the adequacy of its disclosures required under new accounting standards, particularly in areas that require significant judgment or estimates?

Regulatory developments

1. To what extent is the audit committee considering how new areas of nonfinancial disclosure and related metrics are subject to adequate disclosure processes and controls?
2. Has the audit committee discussed how the CAMs were determined by the auditor? Has the committee discussed with management and the auditor the process that should be followed to the extent questions about CAMs are raised by stakeholders?
3. Are there any changes that need to be made to committee charters as a result of regulatory changes?
4. What process does the committee have in place for regular regulatory updates, and is the committee sufficiently engaged in dialogue providing views and input as needed on regulatory consultations?
5. Is the audit committee aware of any potential exemptions from registration with the SEC as a result of recent SEC proposals, and how this might affect capital raising?

Tax

1. What additional investment or tax planning has the organization undertaken in response to the TCJA?
2. Have changes to ICFR been implemented and what key actions have management taken to address the TCJA?
3. What additional compliance procedures have been performed because of the TCJA, and have any additional audit risks been identified? If so, how have they been addressed?
4. Has the company engaged in modeling and scenario planning to weigh the potential impacts of tariffs and other trade policy developments?
5. Has the company considered proactive engagement with the OECD or individual countries on digital tax issues and the broader OECD project?

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