EY Center for Board Matters

What audit committees should consider at the end of 2020 and beyond

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In this 2020 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. With the changing risk landscape, the audit committee's role continues to grow more demanding and complex amid the pandemic and a dynamic and fluid business environment.

This report will assist audit committees as they proactively address recent and upcoming developments in financial reporting, tax, the regulatory landscape and risk management.

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Financial reporting

The Securities and Exchange Commission (SEC or the Commission) staff continues to encourage audit committees to maintain the right "tone at the top" to create an environment and culture that supports the integrity of the financial reporting process. Additionally, stakeholders are requiring businesses to provide more disclosures for a variety of reasons.

They are especially focused on how the continued global COVID-19-driven economic uncertainty and shifting geopolitical developments are impacting the company. From considering the ongoing accounting and disclosure ramifications of the pandemic to implications arising from the changing work environment and the impacts to internal control over financial reporting, audit committees will be contending with a plethora of financial reporting issues. We highlight some of these and other key financial reporting developments and trends to assist audit committees in driving audit quality.

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

Audit committees should assess the key accounting and disclosure implications arising from the ongoing impacts of the pandemic, the changing business environment, and macroeconomic conditions. While the accounting and disclosure implications may range from narrow to extensive, the following are issues to consider:

- Company estimates of the expected recovery and the impact on prospective financial information
- Signs of distress with significant business partners (e.g., industry constraints, abnormal payment activity, changing trade terms, derivative counterparties) and possible revisions to estimates and reserve methodology for credit risk and customer concentrations
- Asset realizability and impairment (e.g., inventory, indefinite-lived intangible assets, including goodwill, long-lived assets, and other investments)
- Impact of the current economic conditions on expected credit losses (such as determination of impairments for loans and investments carried at cost), including considerations around key methods, assumptions, model adjustments and controls
- Revenue recognition, with a focus on assessing implications of new contracts as well as material modifications to existing contracts and arrangements, variable consideration and changes in estimates and collectibility assessments
- Accounting for additional incentives to adjust to customer demand and needs, such as free goods and services
- Accounting effects of material lease modification(s) as companies rethink the footprint of their existing leases, accounting for concessions granted or received and deferral of lease payments
- Compliance with financial and other contractual covenants (e.g., material adverse change clauses)
- Debt modifications, changes to encumbrances and draws on committed credit lines
- Evaluation of going concern and the need to consider management's plan to alleviate the conditions that gave rise to the consideration of a going concern assessment
- Impacts of governmental relief, assistance and stimulus programs, including Coronavirus Aid, Relief, and Economic Security (CARES) Act and Paycheck Protection Program and Health Care Enactment Act (PPP), including accounting for grants, forgivable loans and proceeds received under PPP
- Accounting for income taxes, including the impact of numerous Treasury regulations finalized during the year, income tax provision effects of various foreign government stimulus programs and increasing pressure on the realizability of deferred tax assets, changes in indefinite reinvestment assertions due to cash flow and impairment considerations and provision-to-return adjustments and changes to estimates for differences in the accounting for the CARES Act to the 2019 tax returns filed
- Loss contingencies, changes in assumptions and ranges in estimates related to contractual commitments, guarantees, indemnifications, self-insurance, legal exposures and other contingencies
- Business interruption and other insurance claims and recoveries
- Fair value measurements for financial and nonfinancial assets and liabilities in particular when the determination of fair value is based on a model
- Hedge accounting and the impact of changes in expectation on forecasted transactions in a hedging relationship
- Accounting related to employee transition matters (e.g., termination, severance, furlough) and changes to employment benefits
- Accounting for idle operations and facilities
- Accounting for modification to share-based payment and other incentive-based compensation arrangements and changes in estimates
- Bankruptcy, liquidations and quasi-reorganizations
- Exit or disposal activities and related considerations
- Implications and impacts of restructuring operations in ways that change purpose, design, governance structures or capitalization
- Financial statement disclosure considerations associated with estimates and assumptions, including risks and uncertainties underpinning the aforementioned topics

Companies should continue to update their disclosures about the effects of the pandemic, current market conditions and their expectations for the future. Given heightened uncertainty, now more than ever, it will be important for audit committees to not only understand management's view of future economic conditions, but also validate that the organization provides transparent disclosures around these views.

What we're seeing in SEC comment letter trends

In our review of SEC staff comment letters on periodic reports by domestic registrants on Forms 10-K and 10-Q, we found that the volume of SEC staff comment letters continued to decline (declined by approximately 15% from the previous year). The SEC staff continues to focus on many of the same topics that we highlighted last year. The following chart summarizes the top 10 most frequent comment areas in the current and previous years.

SEC statements and guidance issued this year made it clear that the COVID-19 pandemic and its impacts on the registrant and its business prospects should be effectively discussed in all major sections of a company's periodic reports. 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. We also expect the staff to comment on the new SEC disclosure rules related to significant business acquisitions and disposals, human capital resources and registered debt. 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 30 June*	
Comment area	**2020**	**2019**
Non-GAAP** financial measures	1	2
Management's discussion and analysis (MD&A)***	2	3
Revenue recognition	3	1
Segment reporting	4	8
Fair value measurements****	5	4
Intangible assets and goodwill	6	5
Contingencies	7	*****
Inventory and cost of sales	8	*****
Income taxes	9	6
Signatures/exhibits/agreements	10	9

* 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 1 July 2018 through 30 June 2020. In some cases, individual SEC staff comments are assigned to multiple topics if the same comment covers multiple accounting or disclosure areas.

** GAAP: generally accepted accounting principles.

*** This category includes comments on MD&A topics, in order of frequency: (1) results of operations (51%), (2) critical accounting policies and estimates (24%), (3) liquidity matters (20%), (4) business overview (18%), and (5) contractual obligations (7%).

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

***** This topic was not among the top 10 in 2019.

"SEC statements and guidance issued this year made it clear that the COVID-19 pandemic and its impacts on the registrant and its business prospects should be effectively discussed in all major sections of a company's periodic reports.

SEC comments on accounting and disclosures related to COVID-19 and other COVID-19 observations

- The majority of the SEC staff comments on disclosures relating to the pandemic were issued to companies registering securities offerings. However, these comments could be a leading indicator of where the staff plans to focus its time later during their review of periodic reports.
- The pandemic-related comments to date have focused on the specificity of a company's disclosures of risk factors and the effects of the pandemic in MD&A, including those related to impairment testing, a company's liquidity position and forward-looking information.
- Some comments have been broad and appear intended to elicit disclosure throughout a company's filing. They reflect the overall philosophy of SEC Chairman Jay Clayton and former Division of Corporation Finance Director William Hinman that a company should explain (1) where it stands today operationally and financially, (2) how management is responding to developments and (3) what the future might hold.
- Most companies have concluded that they did not have material changes in internal control over financial reporting (ICFR) related to COVID-19, but some of these companies have elected to expand their disclosures required by Item 308 of Regulation S-K. For example, some companies have disclosed their remote work environment and business continuity plans that were in place to mitigate the effect to the internal control environment. A few companies have disclosed material changes in ICFR that resulted from the effects of COVID-19, such as changes made to the control environment due to the inability to perform interim physical inventory counts. The SEC staff may ask companies to explain how operational changes caused by the pandemic affected ICFR if the disclosures are silent on the effect of the pandemic.
- Well-crafted risk factor disclosures, including any related to the pandemic, typically provide an effective list of the material adverse effects that a company might experience. The SEC staff has used these disclosures as a road map to determine whether disclosure is lacking in other areas of a filing, particularly MD&A, and has asked for more COVID-19 disclosure.

Financial restatement trends

According to a recent report from Audit Analytics, the number of restatements of previously issued financial statements has steadily decreased in recent years and hit a 19-year low in 2019. The top seven accounting issues implicated in restatements disclosed in 2019 were noted in this report as follows:[1]

- Revenue recognition issues
- Cash flow statement classification errors
- Debt, quasi-debt, warrants and equity security issues
- Tax expense, benefit, deferral and other tax-related issues
- Liabilities, payables, reserves and accrual estimate failures
- Accounts/loans receivable, investments and cash issues
- Expense (payroll/selling, general and administrative/other) recording issues

Monitoring these and other trends related to financial reporting may assist audit committees in focusing on the top accounting issues and maintaining high-quality financial reporting.

Internal control environment considerations

With the changing work environment, companies and audit committees will need to consider how having employees work from home may have affected ICFR and disclosure controls and procedures (DCPs) over the content of the company's SEC filings. Audit committees should continue to evaluate how process changes, including people changes (e.g., furloughs, terminations, hiring, reorganizations, prolonged remote work environment) are impacting the performance and effectiveness of key controls and the potential for control deficiencies along with heightened fraud risks. In particular, audit committees should inquire with internal audit as to whether new or different risks have been identified and whether internal controls are designed and operating at an appropriate level to be responsive to the risks identified. Given the changing environment, some other key internal considerations include:

- Key controls related to processes and accounts affected by accounting estimates
- Potential incentives, pressures or opportunities for fraud
- Heightened risk of cyber incidents and controls to safeguard assets
- Impacts of the pandemic on critical service organizations, including how potential modifications to Systems and Organizations Controls (SOC) reporting and delays in the issuance of these service auditor's reports may impact the organization's ICFR

Reference rate reform

Companies will need to focus on making sure they have appropriate processes and controls in place to manage the transition away from the London Interbank Offered Rate (LIBOR) and certain other interest rates that will be discontinued. For companies that elect to use the temporary optional expedients and exceptions in Accounting Standards Codification (ASC) 848,[2] audit committees should verify that the company has processes and controls in place to evaluate whether the contracts met the criteria for relief.

Critical audit matters update

New requirements on the disclosure of critical audit matters (CAMs) in annual reports became effective for fiscal years ending on or after 30 June 2019 for large accelerated filers. For all other companies for which the requirements apply, they become effective for fiscal years ending on or after 15 December 2020.

Some of the most commonly identified CAMs related to intangible assets, revenue, and income taxes. On average, two CAMs were identified per audit report. EY also examined whether company proxy filings discussed the audit committee's role in CAM disclosures. Twenty-one percent of Fortune 100 companies

> "While the COVID-19 crisis may not itself be a CAM, it may be a principal consideration in the auditor's determination as to whether one or more CAM(s) exist, and may also affect how CAMs were addressed in the audit.[3]

[1] Audit Analytics, *2019 Financial Restatements: A Nineteen Year Comparison* report

[2] The relief is temporary and generally cannot be applied to contract modifications that occur after 31 December 2022 or hedging relationships entered into or evaluated after that date.

[3] https://pcaobus.org/Documents/COVID-19-Spotlight.pdf

included disclosure regarding the audit committee's role with respect to CAMs.

As management and audit committees review CAMs and consider the potential financial reporting effects, some key actions include:

- Evaluate whether to make changes to the company's disclosures in response to matters highlighted by the external auditor
- Begin to prepare themselves for potential questions investors and other users of the financial statements may ask regarding the CAM descriptions in the auditor's report
- Work with external auditors to understand any changes to the audit firm's review process related to their reports and how and when the auditor intends to discuss CAMs with the company and audit committee

The Public Company Accounting Oversight Board (PCAOB) has stated that they will continue to monitor CAMs implementation and review whether further guidance is needed. It is imperative that auditors, management, and audit committees maintain a dialogue on CAMs for this reporting requirement.

Additional resources	- Technical Line: Accounting and reporting considerations for the effects of the coronavirus outbreak - SEC Reporting Update: Highlights of trends in 2020 SEC comment letters

How auditors are adapting to the virtual environment

COVID-19 simultaneously disrupted the accounting cycle for companies and auditors. External auditors have been adapting to the new environment and adjusting their audit approach in response to an altered business landscape. While the transition to off-site and remote auditing was already underway for some companies, the pandemic has accelerated this trend across the profession and highlighted how auditors are leveraging technology and data to deliver high-quality audits and focus more on risk identification and business insights. As an example, data analytics have helped audit teams focus on key audit issues raised by the pandemic by flagging potential risks resulting from anomalies and trends in financial data.

While the transition to a remote close and remote workforce has generally been effective for companies and auditors, audit committee chairs noted increasing risks, including cyber-related risks associated with phishing attempts and email security, increased fraud risk factors, and potential changes to internal control over financial reporting.

Heading into the year-end audit, it will be critical that audit committees maintain proactive, open and complete communications with the auditors to keep pace with the changing nature of audits and oversee audit effectiveness and quality. To aid in those discussions, the PCAOB provided the following questions for audit committees to discuss with their auditors to better understand the risks associated with remote work and virtual audits:

- Will additional time be needed to get the audit work done remotely? What complexity does working remotely add to the audit?
- Will working remotely affect productivity of audit engagement team members? If so, does the audit plan need to be updated, and do fees need to be revised?
- Has remote work affected the company's ICFR? If so:
  - Is the auditor including new controls in their assessment or evaluating changes to existing ones?
  - Has the auditor identified any concerns with respect to segregation of duties?
- If a review of the issuer's interim financial information has been completed already, are there any lessons learned that can be applied to the year-end audit?
- Has the auditor assessed potential risks of material misstatement related to cybersecurity, and how does the auditor plan to respond to those risks?

Source: PCAOB's Conversations with Audit Committee Chairs: COVID-19 and the audit [July 2020]

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Tax and other policy-related developments

Global digital tax initiatives, evolving interpretations of US tax reform legislation and ongoing trade volatility have all been contributing to an unpredictable tax landscape for businesses. The COVID-19 pandemic (including responses to the virus) and the US election results introduce 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 can respond rapidly to an ever-evolving tax environment. Adapting and excelling in this environment requires a greater focus on risk and compliance oversight, as well as greater involvement in monitoring policy developments and modeling different potential scenarios. 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.

COVID-19 and ongoing implementation changes stemming from the TCJA

In a year of health, economic and trade disruption, tax policy has played a key role. Governments around the world have responded to the COVID-19 pandemic with economic relief and stimulus measures. In the US, a significant portion of the relief has been offered through the tax code, at a time when businesses continued to implement changes stemming from the Tax Cuts and Jobs Act (TCJA).

Of the roughly $2.8 trillion spent across several US COVID-19 relief bills as of early November, tax provisions have accounted for about $540 billion, with the business tax elements aimed at improving liquidity and employee retention. Tax changes included payroll tax relief, rollbacks of provisions from the TCJA, individual tax relief and other business tax measures. Some of the key tax changes enacted under the CARES Act and other relief measures included:

- Deferral of payment of employers' 2020 6.2% Social Security tax payments (with half paid by the end of 2021 and the rest by the end of 2022)
- An employee retention tax credit
- Relaxing of the TCJA's business interest limitation for 2019 and 2020
- Five-year carryback of net operating losses (NOLs) from 2018, 2019, or 2020
- Temporary removal of the taxable income limitation to allow NOLs to fully offset income
- Changes to the depreciation treatment of qualified improvement property (QIP), making QIP eligible for 100% bonus expensing

In addition to legislative changes, companies have had to contend with a dynamic regulatory landscape that may continue to shift next year. In the latter part of 2020, the IRS and US Treasury Department released a stream of TCJA implementation guidance, much of which addressed complex international tax elements of the tax reform law, such as the global intangible low-taxed income (GILTI), foreign-derived intangible income and base erosion and anti-abuse tax provisions. These changes have tax compliance implications for companies. Looking ahead, there is likely to be increased regulatory audit risk from the continued federal and state enforcement of the TCJA, particularly as the IRS launches new audit campaigns in that area and looks to implement recently issued regulatory guidance.

While some of the TCJA guidance has been in final form, several proposed regulations were also issued. Examples include proposed regulations related to business interest expense limitations, the foreign tax credit and the controlled-foreign-corporation status of a foreign corporation when applying certain tax provisions. Depending on the priorities of the next Presidential administration, the interpretations and policies laid out in the regulations released in these final months of 2020 may be revisited, adding to the uncertainty businesses face heading into 2021.

Beyond the elections

In addition to COVID-19-related impacts and TCJA implementation changes, audit committees will also contend with potential tax policy changes and developments stemming from the change in administration. Looking ahead to next year, the tax legislative agenda will hinge largely on political forces that have yet to completely solidify. While former Vice President Joseph Biden is President-elect, the final political breakdown in the Senate may not be clear until January due to two races in Georgia that are headed to runoffs on 5 January. If Democrats were to win both Georgia elections, they would effectively control the Senate with a 50-50 split (including Independent Sens. Bernie Sanders and Angus King, who caucus and generally vote with Democrats), and Vice President-elect Kamala Harris able to provide a tie-breaking vote. However, if Republicans win at least one of the Georgia races, they will have more than 50 seats and retain control. In either scenario, the majority is extremely slim.

> "Audit committees will also contend with potential tax policy changes and developments stemming from the change in administration.

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

Federal outlook

President-elect Biden has signaled that his first priority will be managing the COVID-19 crisis, including its economic impact. During the campaign, he also outlined a number of other policy priorities, several of which would have implications for tax.

President-elect Biden mapped out a tax plan that included a 28% corporate income tax rate, a global book income minimum tax, an increase in the GILTI rate, and several provisions addressing onshoring, but the likelihood of these significant changes being enacted is limited with a 50/50 or Republican-controlled Senate. Republicans, moderate Democratic senators and House members are likely to resist efforts to increase taxes in general and may be wary of the potential negative impact of tax increases on the economy.

President-elect Biden has also said another key initiative of his presidency will be to revitalize America's middle class. His "Build Back Better" plan prioritizes US manufacturing, infrastructure, clean energy and investments in social programs, which he proposed paying for with tax increases such as a 10% offshoring penalty surtax, changes to the GILTI tax regime, rolling back of tax benefits for high-income real estate investors, and possible tax increases for the "wealthiest Americans."

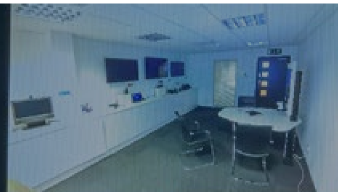
Climate change, health care, education and housing measures may also be proposed, to be financed with tax increases. With the Senate so closely split, it will be challenging for a Biden administration to advance more controversial initiatives, and compromise will be necessary for any significant legislative accomplishments. Since Democrats are shy of the 60 votes needed in the Senate to avoid a filibuster, Democrats will likely be limited to pursuing proposals that might have bipartisan appeal, such as infrastructure, retirement savings proposals and addressing upcoming changes under the TCJA related to the interest deduction, R&D amortization or the expiration of the legislation's provisions for individuals.

State outlook

Companies should also expect to see tax changes at the state and local government level as those governments seek to address growing fiscal gaps from the pandemic's economic fallout and increased resource demands.[4] The post-election tax policy environment at the state and local level will also likely be marked by uncertainty and rapid change. To date, most states have not acted aggressively to address current and looming budget shortfalls caused by the pandemic. If additional federal fiscal relief does not materialize and strains on state finances intensify, states will be forced to act.

The history of state responses to the 2001 and 2008 recessions provide some semblance of a road map of state responses that raised revenue; such responses have focused on short-term, temporary revenue-raising measures ranging from temporary rate increases to short-term limitation of utilization of net operating losses and tax credits. From a state and local tax perspective, 2021 could turn out to be a very active year for both lawmakers and taxpayers across the country.

[4] Scott Roberti, Rebecca Bertothy and David Sawyer, "How the 2020 Elections Could Affect State and Local Tax Policy," *Tax Notes State*, 2 November 2020. https://assets.ey.com/content/dam/ey-sites/ey-com/en_us/topics/tax/ey-how-the-2020-elections-could-affect-state-and-local-tax-policy.pdf



Other policy and global developments: trade issues and global digital tax focus

Trade issues

Under the Biden administration, trade policy may take a less central role, although President-elect Biden has indicated he would work to restore traditional international alliances and re-engage globally on issues such a climate change and trade. The incoming administration will likely be more focused initially on its domestic policy agenda, including dealing with the COVID-19 pandemic, rather than on bilateral trade issues. The new administration will be less likely than the outgoing Trump administration to impose tariffs in bilateral disputes and is expected to seek a more multilateral trade approach, as well as to work to repair trade relationships with traditional US economic allies such as the EU and Japan and with bodies such as the World Trade Organization.

Following the signing of the China-led Regional Comprehensive Economic Partnership trade agreement of 15 Pacific-rim economies, some trade and foreign policy analysts have urged President-elect Biden to reconsider President Trump's decision to withdraw the US from the Trans-Pacific Partnership (TPP) trade agreement with the view toward constraining China's global trade leadership ambitions. President-elect Biden, however, has indicated that he plans to focus his administration, at least initially, on domestic policy issues.

Global digital tax focus

Audit committees should continue to monitor the new tax policies, regulations and other developments beyond the US. The Organisation for Economic Co-operation and Development (OECD) continues to move forward with its project to address the tax challenges of the digitalization of the economy in a globally coordinated way, with several significant developments in 2020.

On 12 October 2020, the OECD released a series of major documents in connection with this project, commonly known as "BEPS 2.0."[5] The documents included blueprints on the two pillars of the project. The aim of Pillar One is to revise the global allocation of taxing rights on business profits in a way that expands the taxing rights of market jurisdictions. Pillar Two involves the development of global minimum tax rules with the objective of making sure that global business income is subject to at least an agreed minimum tax rate.

No consensus has been reached yet among the more than 130 member jurisdictions of the "inclusive framework" collaborating on the project. But, with the release of these blueprints, the OECD continues to advance the initiative with a target of agreement by mid-2021 and has announced plans for consultations with stakeholders.

Historically, the US has been a very active participant in OECD tax discussions. The changes President-elect Biden has proposed to the existing GILTI tax rules in the US would more closely align those rules with the design the OECD is pursuing, and one might expect a Biden administration to continue to support that part of the project. As for the tax jurisdictional and profit allocation rules, both political parties appear opposed to the proposed OECD changes, signaling that under a President Biden, changes to tax jurisdictional and profit allocation rules would remain of concern to the US government.

While several political and technical issues still need to be resolved, this project has the potential to affect all multinational entities, not just digital businesses, by modifying long-standing global international tax standards and practices. Boards and audit committees should stay apprised of the latest developments in this effort and consider the opportunities for providing feedback to policymakers on the rules being developed.

[5] BEPS: base erosion and profit shifting.

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Regulatory developments

Under the leadership of Chairman Clayton, the SEC has included in its agenda a range of rulemaking activities aimed at improving the process for raising capital in the US. The SEC has been focused on achieving some of Chairman Clayton's top priorities: increasing the attractiveness of the US public capital markets for companies and facilitating more investment options for retail investors, while preserving and enhancing investor protections.

Disclosure effectiveness and simplification efforts continue

One area of focus for the SEC under Chairman Clayton's leadership has been to encourage capital raising in the public capital markets, and improving investment opportunities for "Main Street" or retail investors. In 2020, the SEC has continued to take actions intended to modernize disclosure requirements to reduce regulatory burdens for companies while maintaining investor protections. While the changes have been evolutionary rather than revolutionary, this

sustained effort should have a meaningful cumulative impact on the SEC's disclosure requirements. Some of the key amendments passed during the year include:

- Final rule amendments to financial disclosure requirements for registrants to provide information about significant acquisitions and disposals, aiming to enhance the quality of information that investors receive while eliminating unnecessary costs[6]
- Final rule amendments to reduce financial disclosure requirements for companies that conduct certain registered debt offerings[7]
- Final rule amendments to modernize and simplify disclosures relating to the description of business, legal proceedings and risk factors as well as new disclosure requirements relating to human capital given the increasing importance of human capital to company performance and long-term value[8]
- Final rule amendments to auditor independence meant to reduce compliance burdens and costs for registrants and auditors
- Final rule amendments to further simplify and modernize MD&A, including elimination of the contractual obligations table and elimination of selected financial data disclosures[9]

> “In 2020, the SEC has continued to take actions intended to modernize disclosure requirements to reduce regulatory burdens for companies while maintaining investor protections.

[6] To the Point: SEC streamlines disclosure requirements for acquisitions and disposals of businesses
[7] To the Point: SEC streamlines disclosure requirements for certain registered debt offerings
[8] To the Point: SEC streamlines some Regulation S-K disclosures and requires human capital disclosures
[9] To the Point: SEC eliminates certain MD&A requirements and revises others to make disclosures more useful

How to approach the SEC's new human capital disclosures

Many investor groups have been calling for expanded human capital disclosures for some time, and these new disclosures will receive significant attention from key stakeholders. As such, this may also be an opportunity for companies to further enhance their disclosures by discussing their plans and strategic strengths associated with human capital placed in the context of their business objectives and strategies. These are increasingly important as greater emphasis is placed on the role of human capital in underpinning and enhancing long-term value — especially in those sectors that are highly dependent on skilled, well-developed and engaged personnel.

Examples of measures, objectives and strategies that companies might disclose include:

- Overarching human capital resource strategies, goals and management
- Employment and recruitment strategies and practices
- Diversity and equality
- Employee retention strategies, goals and measures
- Compensation and incentive mechanisms
- Employee benefits, collective bargaining and grievance mechanisms
- Employee engagement
- Investment in employee training
- Employee health and well-being
- Succession planning
- Legal or regulatory proceedings related to employee management

The World Economic Forum's International Business Council's recent report on measuring stakeholder capitalism along with the Embankment Project for Inclusive Capitalism may provide some helpful detail about metrics of interest to stakeholders, including investors. Additionally, many investors are requesting that companies consider sector-specific metrics issued by the Sustainability Accounting Standards Board.

Focus on improving smaller companies' ability to raise capital

Consistent with prior actions intended to reduce burdens on smaller companies in the public capital markets, the SEC has adopted final rules to:

- Expand the number of companies that are considered non-accelerated filers and extended filing deadlines and an exemption from obtaining an auditor's attestation on the effectiveness of ICFR
- Change the definition of "accredited investor" and other changes to expand investment options for individual investors
- Harmonize and streamline the exempt offering framework

Continued focus on the proxy process

The SEC has continued its actions to review and potentially modify various aspects of the proxy process in 2020. Key developments include:

- Adopted amendments to enhance disclosures by proxy advisory firms
- Adopted changes to the shareholder-proposal process

Other areas of SEC focus: emerging technology, cybersecurity and enforcement

Emerging technology

The SEC is expected to continue monitoring the use of distributed ledger technology, digital assets and initial coin offerings (ICOs) in the capital markets, utilizing its Strategic Hub for Innovation and Financial Technology (FinHub) to address issues raised by new technology in the capital markets.

Cybersecurity

The Commission and its staff continue to monitor cybersecurity risks in the market. In January 2020, the Office of Compliance, Inspection and Examination (OCIE) issued Cybersecurity and Resiliency Observations, describing practices it has observed to manage and combat cybersecurity threats. Audit committees and companies should review this report to gain a stronger understanding of practices relating to governance and risk management around access rights and controls, data loss prevention, mobile security, incident response and resiliency, vendor management, and training and awareness.

SEC enforcement activities

Audit committees should keep abreast of SEC enforcement activities to help them assess the adequacy of controls and monitoring procedures to prevent material errors, fraud or noncompliance with laws and regulations. This year, the SEC's Division of Enforcement (the Division) took action against wrongdoers who sought to take advantage of the uncertainty and volatility in the markets stemming from the global pandemic and also worked to "proactively identify and monitor areas of potential misconduct associated with COVID-19, and to detect and address potential misconduct in areas such as insider trading, financial fraud and issuer disclosure, and misconduct by regulated entities and individuals."[10] Enforcement priorities include:

- Holding individuals accountable, including gatekeepers: The SEC's Division of Enforcement 2020 Annual Report highlights the high percentage of the SEC's actions that involved charges against individuals. This reflects the Commission's approach of holding individuals accountable as one of the most effective methods for achieving deterrence.
- Scrutiny of financial reporting, including non-GAAP measures and key performance indicators (KPIs): The Division has pursued cases against companies for problematic practices relating to all aspects of the disclosures about financial and operational performance. This includes failures in areas ranging from internal control over financial reporting to issuers' improper use of non-GAAP measures and KPIs.

"

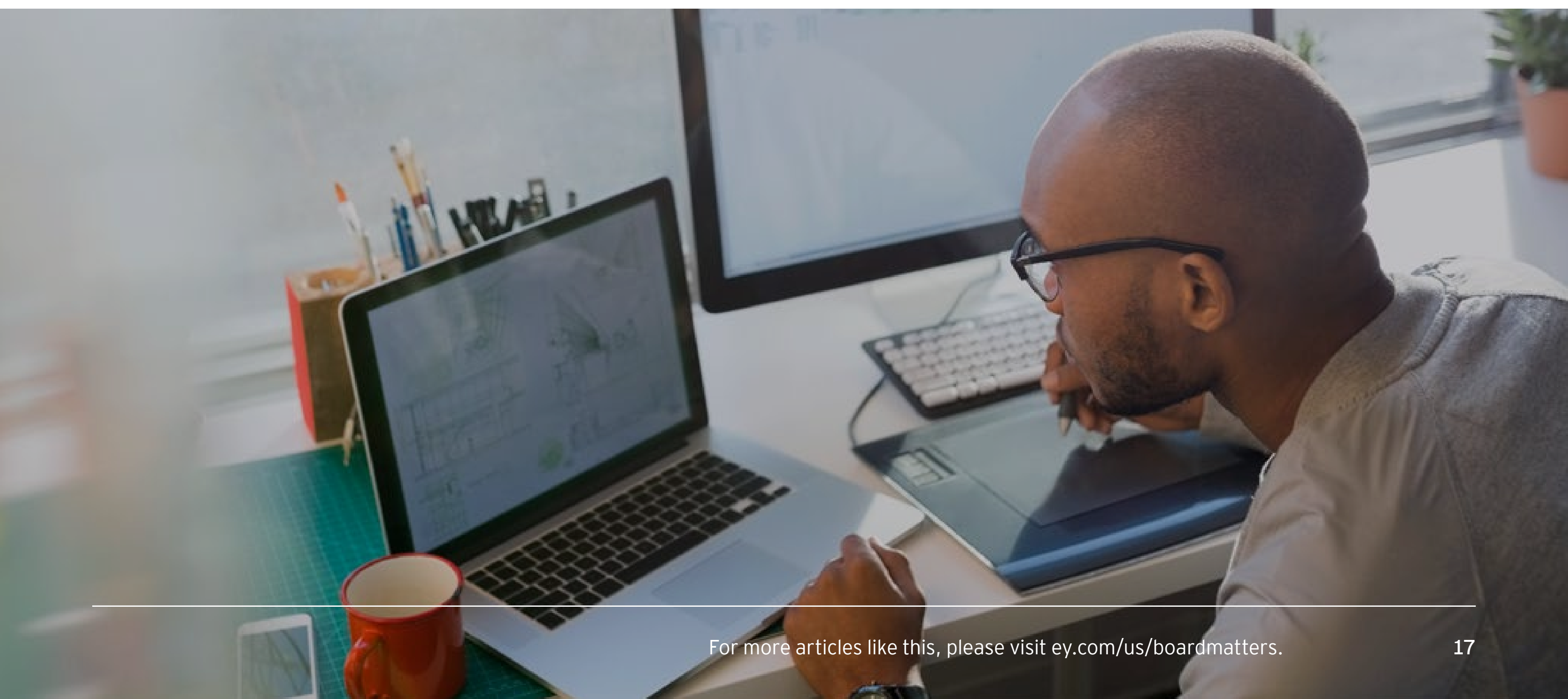
Audit committees should keep abreast of SEC enforcement activities to help them assess the adequacy of controls and monitoring procedures to prevent material errors, fraud or noncompliance with laws and regulations.

[10] https://www.sec.gov/files/enforcement-annual-report-2020.pdf

Other policy developments

The relationship between the US and Chinese governments continues to be strained in recent months, and one area in which this tension is being felt relates to the US public capital market. Regulations and legislation are being developed that could limit Chinese companies' access to the US capital market in light of the inability of the PCAOB to inspect the auditors of those companies.

- The Holding Foreign Companies Accountable Act (HFCAA) legislation has been passed by Congress to require the identification and, ultimately, the delisting from US securities markets of companies whose auditors are located in jurisdictions that prevent PCAOB inspection and enforcement access.
    - The legislation's primary focus is on China-based companies for which securities are registered or traded in US markets and where, as a result of unresolved issues between the US and China regulators, those companies' China-based independent audit firms have not been subject to inspection and oversight by the PCAOB. However, the legislation is broad enough to encompass companies from any other jurisdiction where the PCAOB is unable to conduct local inspections.
    - Initially, such companies will be subject to heightened SEC disclosure requirements and then, after "three consecutive non-inspection years," their securities will be delisted from trading in the US.
        - One area expected to be clarified through regulation is how the legislation covers audit component work, such as that performed by China-based accounting firms for companies located in other jurisdictions but with operations in China.
        - With regard to the heightened disclosures, the HFCAA requires the SEC to pass certain rules, including to mandate that issuers from jurisdictions that prevent PCAOB inspections to:
            - Submit to the SEC documentation establishing that the covered issuer is not "owned or controlled by a government entity in the foreign jurisdiction."
            - Disclose for each non-inspection year certain information, including about ownership and controlling interests held by government entities and the name of any Chinese Communist Party officials on the board of directors of the issuer or its operating entity.
    - We expect President Trump will sign this bill into law.
- Separately, the SEC also has taken steps and indicated it is considering further action to address the lack of PCAOB access to the auditors of US-listed Chinese companies. This includes enhanced disclosures and guidance that focus on the potential risk to investors.
    - In December, the SEC staff issued CF Disclosure Guidance: Topic No. 10 regarding considerations for companies based in or with the majority of their operations in China. In addition to highlighting disclosure considerations for China-based issuers, the guidance outlines risks to



investors due to differences between the legal, regulatory and operating environments in the US and China.

- In August 2020, the US SEC issued a statement indicating that staff are preparing proposals to implement recommendations of the President's Working Group on Financial Markets (PWG), which are aimed at addressing US government concerns about the risks to investors due to the lack of US regulatory access to certain US-listed foreign issuers and their auditors. The PWG recommended policy changes with respect to the treatment of companies from jurisdictions viewed by the US government as not cooperating with US regulators, including China, in the US capital markets. The report's recommendations included:
  - Requiring PCAOB access to audit workpapers of a listed company's auditor as a condition for initial and continued listing on a US exchange; as an alternative, the recommendation would permit companies in affected jurisdictions to engage an affiliated US-member registered public accounting firm to serve as the co-auditor of the listed company's annual financial statements with an auditor in that jurisdiction
    - Several news reports[11] indicate that a rule proposal to implement this PWG recommendation could be put out for comment by the end of 2020, although that may be impacted by the passage of the HFCAA.
  - Requiring additional disclosures and due diligence by market participants from or with investments in noncooperative jurisdictions
- Previously, SEC Chairman Clayton, PCAOB Chairman William Duhnke and senior members of the SEC staff had issued a statement expressing concerns about the risks of investing in companies that are based in or have significant operations in emerging markets, including China. The statement notes the risk that these companies' disclosures could be incomplete or misleading and that investors will have less recourse in emerging markets given the limits on the SEC's and PCAOB's oversight and enforcement in some jurisdictions. The statement says it is imperative that companies based in or with significant operations in emerging markets, as well as their audit committees and auditors, fulfill their responsibilities to (1) prepare and provide high-quality, reliable financial information and other disclosures and (2) provide accurate and complete risk disclosure about the rights and remedies of US regulators and investors.

[11] https://www.wsj.com/articles/sec-pursues-plan-requiring-chinese-firms-to-use-auditors-overseen-by-u-s-11605614403

[12] Measuring Stakeholder Capitalism: Top Global Companies Take Action on Universal ESG Reporting, World Economic Forum, 22 September 2020

Environmental, social and governance

The fast-evolving significance of environmental, social and governance (ESG) matters to investors, employees, customers and other key stakeholders (including regulators) is causing audit committees and boards to deepen their understanding and oversight of ESG policies and disclosures. Forward-looking companies and boards are shifting their frame from ESG disclosure compliance and/or public relations to robust ESG policies as a strategic differentiator. Key issues in boardroom discussions include:

- Understanding which ESG topics are of highest priority to a company and its stakeholders
- Integrating ESG into the firm's strategy, purpose, and risk management processes
- Setting appropriate goals and measuring progress
- Allocating oversight responsibilities at the board level

To the extent ESG metrics are key performance indicators disclosed in an SEC filing, it is critical that audit committees consider and understand:

- Data quality and controls
- Disclosure processes and controls
- Consistency in disclosures and communications across the company's various external reporting outlets (e.g., SEC filings, earnings releases, annual report and shareholder letter, and sustainability report)
- The role of internal and external audit

The World Economic Forum's International Business Council released a set of 21 core ESG metrics to be reported by companies in all industries and geographies.[12] Using this

Looking ahead, there is growing expectation that the SEC will consider new ESG disclosure requirements under a Biden administration.

or other external frameworks can help companies align their sustainability efforts and reporting with globally recognized standards.

Looking ahead, there is growing expectation that the SEC will consider new ESG disclosure requirements under a Biden administration. Requiring public company disclosure of climate risks is part of President-elect Biden's campaign platform, and the two sitting Democratic SEC commissioners have pushed for SEC action in this area.

PCAOB outlook and developments

In the current year, the PCAOB released the six largest US firm inspection reports in a new user-friendly format. These new inspection reports are meant to provide clearer and more useful information to the public. Refer to PCAOB's *Guide to Reading the PCAOB's New Inspection Report*,[13] which details key changes to the inspection reports.

As part of the PCAOB's strategic goal of proactive stakeholder engagement, the PCAOB engaged with audit committee chairs during its 2020 inspections. The PCAOB has published *Conversations with Audit Committee Chairs: COVID-19 and the Audit*,[14] which summarizes certain of the common themes the PCAOB heard from audit committee chairs related to the effects of COVID-19 and the audit. The two major themes covered in this document include the increased risks associated with remote work and the impact on auditor communications with the audit committee.

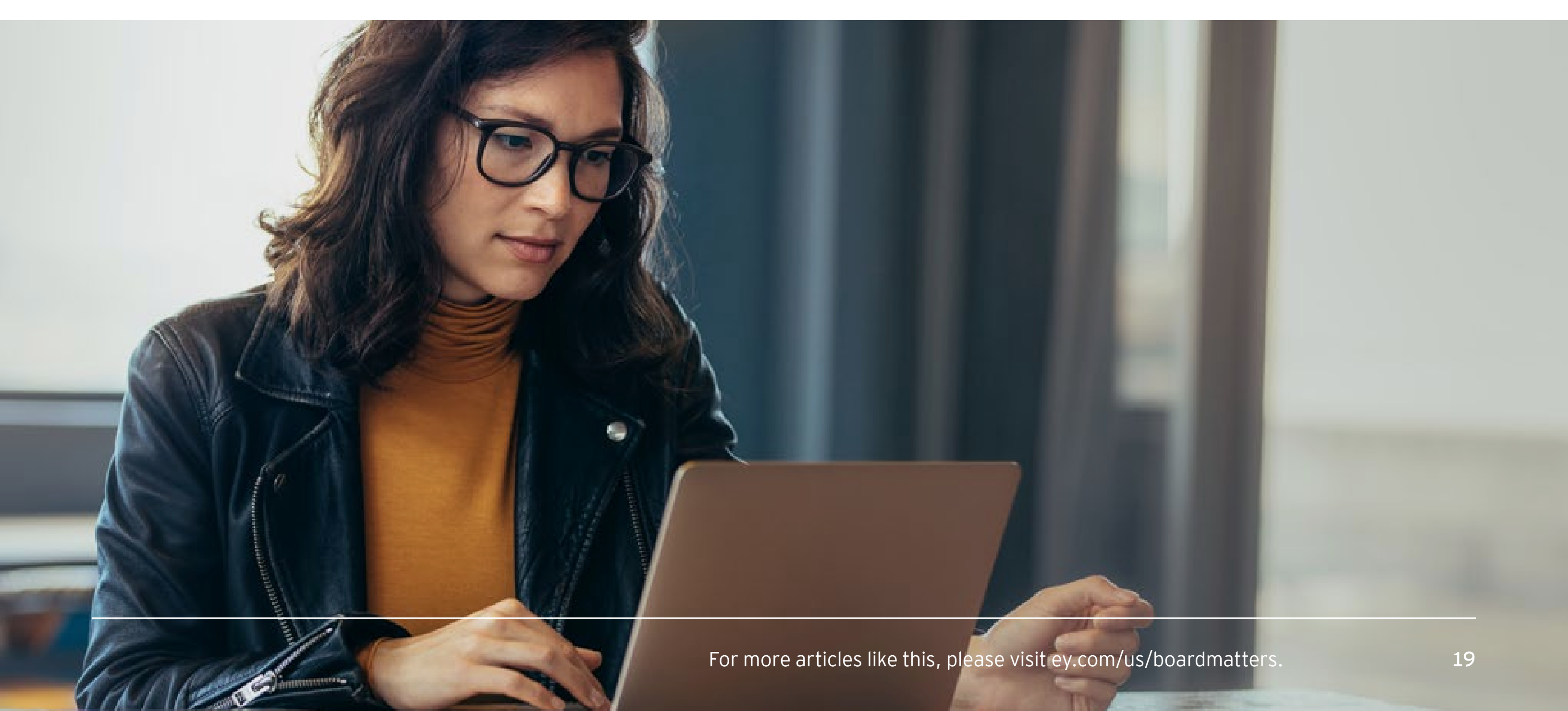
The PCAOB's inspection findings, enforcement matters and areas of focus should be considered by registrants, external auditors, and the audit committee. In October 2020, the PCAOB issued its *Staff Update and Preview of 2019 Inspection Observations*,[15] which highlights both good practices observed during audit inspections as well as areas of recurring deficiencies. Audit committees may find the observations useful as they engage with auditors.

Additional resources	- How to approach the SEC's new human capital disclosures - Five ways boards can unlock ESG's strategic value - Audit committee reporting to shareholders in 2020

[13] https://pcaobus.org/Inspections/Documents/Inspections-Report-Guide.pdf

[14] https://pcaobus.org/Documents/Conversations-with-Audit-Committee-Chairs-Covid.pdf

[15] https://pcaobus.org/Inspections/Documents/Staff-Preview-2019-Inspection-Observations-Spotlight.pdf



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Risk management

In the current COVID-19 pandemic landscape, organizations are faced with an unprecedented duality: of managing the transition to a "new normal," while also reimagining the future of work and business. The recent pandemic has also brought to the forefront the current state of enterprise risk management (ERM) and highlighted the interconnectedness of risks and the velocity at which the risk landscape can change.

In this environment, boards and audit committees are revisiting risk management practices to make sure that risks are managed effectively across the organization and 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, resilience will need to be an organizational priority every day, not just in times of crisis.

Advancing risk oversight to enable enterprise resiliency and agility

Prior to the pandemic, boards were concerned that their organizations were insufficiently prepared for an event regardless of likelihood. The most recent EY Global Board Risk Survey[16] indicated that only 21% of boards felt their organization was very prepared to respond to an adverse risk event from a planning, communications, recovery and resilience standpoint.

With organizations facing the prospect of quickly and effectively responding to the "new" business environment, there is a renewed focus on enterprise resiliency that relies on coordinated risk assessment, planning, monitoring and response across the enterprise. Leading boards and audit committees are motivated to enhance the oversight of ERM, make sure that the ERM process incorporates recent lessons from the pandemic, and evaluate ways to adapt and strengthen ERM.

As organizations look to enhance risk management, some key areas of focus include improved risk identification (including the detection of weak signals of risks that are emerging slowly), more rigorous scenario planning, simulations, stress testing over more variables and extremes, disaster response/contingency planning, incorporation of external data/perspectives, and the need to better leverage technology/digital experience.

Leading organizations have also been changing their resiliency planning efforts and evolving their risk frameworks, processes, and controls to allow them to be more agile and resilient. Resiliency planning should involve more sophistication and build more agility into the organization. This includes using data-enriched, multi-risk and multi-step scenarios that stress test the organization's ability to respond to complex operational threats, mitigate the impact to customers and critical services/suppliers, and withstand a range of adverse economic effects. Some other key considerations and practices include:

- Embrace data to get ahead of threats, build resiliency and drive decision-making that aligns to corporate strategy and risk appetite: leverage predictive and prescriptive risk intelligence as a means of gleaning advance notice on emerging risks, future trends, potential loss and risk exposures, and market pivot points to enable new business models and development of new strategies
- Examine megatrends and disruptive forces (including macro considerations, industry and adjacencies) as part of the strategy-setting process and assess the related implications to the business
- Review outcomes of scenario plans and stress tests and assess implications to liquidity and financial flexibility, supply chains and changes in operating models (e.g., adapting to increased online activity and COVID-19-related governmental requirements and community health matters); evaluate how these changes may also impact key workforce assumptions and related risks (e.g., changes in workforce portfolio, shift to remote work and related implications, training and re-skilling needs, productivity changes)
- Assess and manage risk aggregation and interdependencies across the company's entire value chain (including resiliency/suitability of its supply chains and other third parties on which the organization relies)
- Enhance ERM processes and controls given changes in risk profile/appetite to address emerging risks such as increased cybersecurity and privacy issues related to digital transformation and remote work, geopolitical issues relating to the change in US administration, and the shifting regulatory environment

"With organizations facing the prospect of quickly and effectively responding to the "new" business environment, there is a renewed focus on enterprise resiliency that relies on coordinated risk assessment, planning, monitoring and response across the enterprise.

[16] https://www.ey.com/en_us/board-matters/global-board-risk-survey

Revisiting the three-lines model as a means of enhancing risk management

In light of the Institute of Internal Auditors' recent release of the "three lines model,"[17] audit committees should evaluate whether the organization has reassessed its risk governance structures and processes to achieve more effective alignment, collaboration, accountability and objectives. The recent pandemic has exposed various weaknesses in the traditional three-lines model framework, including lack of risk ownership in the first line, too much focus on compliance and lack of strategic/actionable/data-driven risk insights from the second line, lack of training/education on evolving key risks, ineffective reporting structures (e.g., chief risk officer reporting structure), an over-reliance of internal audit on the concept of independence, and misalignment. Audit committees should consider assessing whether these weaknesses exist and discuss with management ways to optimize the three-lines model that is efficient and fit for purpose.

Audit committees should also rethink the internal audit function's role (including audit plans and use of third parties to supplement and/or provide assurance on key risks) and encourage internal audit to be more agile (e.g., through investments in digital assets, analytics and automation), nimble (e.g., working with the business on the risks that matter) and forward-looking to drive more change through the three-lines model.

> "
> The recent pandemic has exposed various weaknesses in the traditional three-lines model framework.

Enhancing oversight of cybersecurity and privacy

Cybersecurity and privacy related risks are intensifying, particularly with widespread remote working and increased online interactions amid the pandemic. The rapid adaptation of multiple business processes and protocols to enable this virtual environment has exponentially increased the corporate attack surface and introduced new risks to the confidentiality, integrity and availability of critical company data and supporting systems.

Boards and audit committees should continue to remain vigilant and enhance their oversight over these areas by:

- Setting the tone at the top: demonstrating that cybersecurity-, data- and privacy-related risks are critical business issues by increasing the board and/or committee's time and effort spent discussing the topic
- Staying up to date: increasing the frequency of board and/or committee updates on specific actions to address new cybersecurity and privacy issues and threats as a result of the seismic shift to remote work
- Determining the value at risk: understanding the company's value at risk in dollars beyond insurance and reconcile against the board's risk tolerance
- Embedding security from the start: embrace a "Trust by Design" philosophy by designing new technology, products and business arrangements with security in mind
- Independently assessing the Cybersecurity Risk Management Program (CRMP): confirm the CRMP is independently and appropriately assessed by a third party with their direct feedback to the board
- Understanding protocols: obtain a thorough understanding of the cybersecurity incident and breach escalation process and protocols
- Managing third-party risk: understand management's processes to identify, assess and manage the risk associated with service providers and the supply chain
- Testing response and recovery: have the company's ability to respond and recover tested through simulations and arrange protocols with third-party professionals before a crisis
- Monitoring evolving practices: stay attuned to evolving board and committee cybersecurity oversight practices and disclosures

[17] The Institute of Internal Auditors' Three Lines Model: An update of the Three Lines of Defense report, 2020

Further privacy considerations

COVID-19 is exacerbating the issues and the complexity of privacy-related risks (including ethical considerations) as governments and businesses experiment with new technologies to track and contain the outbreak (e.g., location tracking). The pandemic has also raised privacy concerns around employee health data with more businesses taking employees' temperatures and keeping records of those diagnosed with COVID-19.

As companies explore new ways to gather and use data, these risks are becoming fundamental to board discussions about strategy and risk. In this environment, audit committees should continue to understand and assess 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 may 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 businesses face heightened fraud and corruption risks in the current environment, there is renewed focus on enhancing a culture of integrity and mitigating conduct- and corruption-related risks. Companies and audit committees 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 an effective compliance program that promotes ethical behavior above and beyond compliance with laws. Audit committees should re-evaluate the organization's corporate compliance program in light of the Department of Justice (DOJ) Criminal Division's revised guidance issued in June 2020. Specifically, the DOJ expects to see the following five components as part of each compliance function it reviews:

- Commitment from management
- Continual risk assessments
- Effective internal controls
- Ongoing testing and auditing
- Training

In addition to monitoring for the operating effectiveness of compliance programs, audit committees should encourage organizations to enhance compliance programs with AI-enhanced robotic process automation to not only alleviate compliance executives from routine, time-consuming tasks, but also allow for richer risk insights to help shape strategic decisions. Leading organizations are considering automation and advanced analytics technologies in compliance areas, such as vendor due diligence, email and social media monitoring, anti-bribery and anti-corruption, complaint management (e.g., whistleblower hotlines), data protection and privacy, time and expense compliance, regulatory changes, and regulatory and management reporting.

Lastly, given the shifting business and work environment, 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.

Additional resources

- Global board risk survey: four ways to advance risk oversight
- What companies are disclosing about cybersecurity risk and oversight

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Questions for the audit committee to consider

Financial reporting

1. Have there been any material changes to internal controls over financial reporting or disclosure controls and procedures to address the changing operating environment? Have any cost saving initiatives and related efforts impacted resources and/or processes that are key in internal controls over financial reporting? If so, has management identified mitigating controls to address any potential gaps? Has management and/or internal audit taken additional steps to address heightened risk of fraud in the current environment?
2. Are there any resource concerns and, if so, what are the mitigating plans? Has management confirmed whether specialists routinely used by the company to assist in complex financial reporting inputs (e.g., valuation, impairment, pension) or in internal audits (e.g., IT, cybersecurity) have the bandwidth and ability to meet the company's financial reporting needs?
3. How is the company adjusting its disclosures to adapt to evolving events and planning for COVID-19-related uncertainties going forward?
4. What approach has management taken to consider multiple scenarios related to its projections and underlying assumptions that are expected to have a material impact on the results of operations or capital resources? Have there been material changes in controls and processes to evaluate the reasonableness of the assumptions and key estimates?
5. 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 around 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 re-evaluation of critical audit matters and how will auditor reporting requirements be impacted?

Tax

1. Did management optimize the corporate tax benefits available in the CARES Act (i.e., maximized the employee retention credits, all possible deductions into the 2020 tax year if a net operating loss is expected to be carried back or applied for immediate refunds of alternative minimum tax credits for liquidity purposes) and/or other foreign government stimulus tax provisions?
2. Have the organization's tax planning strategies been re-evaluated to address possible shifts in tax policy changes (including those that may arise post-US election), supply chain, workforce, and capitalization?
3. Has the company engaged in modeling and scenario planning to weigh the potential impacts of tax- and trade-related developments?
4. What additional audit procedures has the audit firm incorporated as a result of COVID-19 and the changing tax environment? Have there been any additional audit risks identified? How were they addressed?
5. How is the company staying informed of global, federal, state and local tax policy changes and related developments? Is the company considering the outlook for future COVID-19-related legislation?

Regulatory developments

1. 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?
2. To what extent is the audit committee considering how new areas of nonfinancial disclosure and related metrics (e.g., human capital disclosures and other ESG-related metrics) are subject to adequate disclosure processes and controls?
3. Has the company benchmarked its disclosure practices around key ESG matters with those of its industry and proxy peers to identify areas of improvement?
4. 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?
5. In light of the changing environment, what additional voluntary 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?

Risk management

1. Do the organization's ERM practices incorporate forward-looking insights and use of data analytics to determine trends and predictive indicators? Has the audit committee reviewed the effectiveness of management's risk management programs in the wake of the pandemic?
2. How is the organization deploying new tools and technologies to identify patterns and correlations in company data to identify potential warning areas? How can the organization act upon weak signals, aligning the increase in the organization's intensity to the velocity of the underlying risk?
3. 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?
4. How is management understanding and monitoring the effectiveness of risk management of critical third parties with respect to financial and operational resiliency, IT security, data privacy, culture, and environmental, social and governance factors?
5. Are there any concerns with the company's (risk) culture given the ongoing remote environment?
6. Has the organization revisited and updated its training programs to consider the current and changing business landscape, new controls, new systems and revised regulations?

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