Introduction

Audit committees continue to shoulder significant responsibilities in overseeing their companies’ compliance with financial reporting, tax laws, regulatory requirements and risk management. Based on the EY Center for Board Matters’ insights, this document is designed to help audit committee members prepare for their discussions with management. We pose a series of questions for the audit committee to consider and provide links to additional information.
Financial reporting

Background

The financial regulatory environment continues to grow in complexity, with regulators and standard setters requiring businesses to provide more disclosures. In the US, new accounting standards issued by the Financial Accounting Standards Board and the U.S. Securities and Exchange Commission (SEC) scrutiny of disclosures pose particular challenges, raising questions about whether management is prepared to comply with these requirements.

Further discussion

Recurrent recognition standard and lease accounting standard

The new revenue recognition and lease standards will be effective for calendar-year registrants in 2018 and 2019, respectively. According to SEC Staff Accounting Bulletin (SAB) Topic 11.M, “registrants should discuss the potential effects of adoption of recently issued accounting standards in registration statements and annual reports filed with the Commission.” Audit committees should ask management to report to them about management’s implementation plans and transition method, as well as the expected effects of these two new accounting standards on the company’s financial statements and forecasts.

As registrants evaluate and determine the quantitative and qualitative effect of the new standards, their SAB Topic 11.M disclosure, both within the notes to the audited financial statements and in MD&A in filings with the SEC, should evolve through the adoption date. The SEC staff expects more robust disclosures in upcoming filings with the SEC about how registrants anticipate their financial statements will be affected by the new standards. Recent comments by SEC officials on this topic suggest it will be a focus area in SEC filing reviews during 2017.

Focus on non-GAAP financial measures

In May 2016 the SEC staff released updated Compliance and Disclosure Interpretations (C&DI) providing more explicit guidance on when non-GAAP measures may violate SEC rules. Many of the staff’s comments since then have focused on compliance with the updated interpretations in all company communications with investors and the public, particularly earnings releases. In addition, the SEC staff has continued its focus on compliance with Item 10(e) of Regulation S-K, including clear labeling of adjustments to derive non-GAAP measures, relative prominence, reconciliation to the most directly comparable GAAP measure and clear disclosure about the usefulness of non-GAAP financial measures to investors.

Management’s discussion and analysis

The SEC staff has continued to focus on the discussion of critical accounting estimates and policies in MD&A, requesting more insight into the uncertainties and assumptions involved and the variability that is reasonably likely to result. Other MD&A focus areas include: (1) results of operations, including identifying and quantifying underlying drivers for each factor that materially contributed to changes in individual income statement line items or that is reasonably likely to have a material effect on future earnings; (2) performance metrics; and (3) effects of known trends and uncertainties on a registrant’s expected results of operations, liquidity and capital resources.
Questions to consider

1. What internal controls has been designed and what key actions have been taken by management to implement the new revenue recognition and lease standards, and what key actions are needed to improve readiness for implementation?

2. What is the company’s plan for periodically updating the disclosures under SAB Topic 11.M on the effect of new accounting standards?

3. What communications have been made to stakeholders regarding the new standards? What are the company’s plans for updating stakeholders?

4. What is the status of the company’s adoption of the new revenue standard? Does the company have sufficient resources for an effective implementation of the new standard? And if not, have appropriate risks and uncertainties about the impact of the new accounting standard been disclosed in the company’s filings with the SEC and other investor communications?

5. What is the expected effect of adopting the new revenue standard on the company’s results of operations (revenue line and other indirect impacts on share-based compensation, income tax provision, etc.), future financial information, compliance with bank covenants and future capital resources and liquidity needs?

6. Has the company reconsidered the appropriateness of its non-GAAP measures in light of the updated SEC Staff C&DIs issued in May 2016? Are similar and consistent non-GAAP measures used by peer companies? Are adjustments of the same nature (both favorable and unfavorable) applied consistently to derive the non-GAAP measure?

7. What new disclosure controls has management implemented to address compliance with the updated SEC staff guidance on non-GAAP financial measures?

8. Has the company evaluated the implications of Brexit on matters such as inventory reserves, asset valuations, recoverability of receivables, going concern considerations, deferred tax asset valuation allowances?

9. How and to what extent will ICFR and reporting on ICFR be affected by any identified control deficiencies? Are control deficiencies being adequately evaluated as possible material weaknesses? Are there any material ICFR changes requiring disclosure?

Reference library

- SEC Comments and Trends: An analysis of current reporting issues
- 2016 AICPA National Conference on Current SEC and PCAGB Developments
Tax

Background

Tax policy and controversy are high on the list of issues that audit committees should follow closely in the coming year, especially in light of current geopolitical events. Global forces are driving greater investor and government demand for tax transparency and information sharing, creating uncertainty and risk for companies that are being asked to disclose their tax information more frequently, in new formats, and to a wider audience than ever before.

International tax changes are transforming the global tax environment in which multinational companies (MNCs) operate. In this environment, MNCs are coming under additional scrutiny with respect to taxes paid in various jurisdictions. As a result, audit committees must stay informed about the new tax landscape, especially as governments modify tax policies and call for increased transparency.

Further discussion

Global focus on base erosion and profit shifting

Policymakers around the world are scrutinizing the global tax profiles of MNCs, questioning MNCs’ local tax positions and seeking greater transparency into their global tax footprint. Supranational organizations such as the Organisation for Economic Co-operation and Development (OECD) will continue to be leaders in setting the global tax policy agenda, aiming for cooperation and consistency across country borders. The reverberations are still emanating from the OECD’s Base Erosion and Profit Shifting (BEPS) initiative as countries (including the United States) implement their 15-item action plans, where country-by-country reporting is now required by tax authorities.

In tandem with the OECD’s BEPS efforts, the European Commission (EC) continues its investigations into “State aid.” These investigations have created uncertainty for MNCs and have been criticized by US policymakers, due in part to their retroactive nature (up to 10 years) and perceived targeting of US MNCs.

Given the potential impact of the BEPS-related changes, audit committees should seek frequent updates on the changing global tax environment and the expected impact of such changes on the company’s income tax provision.

US tax reform

The new administration and post-election shifts in state governments will likely result in a reexamination of tax policy. The federal statutory corporate income tax rate is seen as too high, and some suggest the international tax system encourages profit shifting to low-tax jurisdictions, eroding the US tax base. Audit committees need to anticipate tax policy changes at both the federal and state level.

Audit committees should:

- Confirm that management analyzes the effects on the supply chain and international investments as new tax policies take shape
- Understand the effects of the proposed duty and tariff reforms on exporters and importers as well as those dealing with commodities not available in the US
- Understand the implications of the various proposed income tax reforms, such as the Republican proposal to allow companies to immediately expense all capital expenditures except real estate
Digital tax developments

Driven by revenue pressures and shrinking headcounts, tax authorities in the Americas and elsewhere are increasingly relying on digital methods to collect taxpayer data and administer tax systems. Amid increasing demands for tax transparency by governments and supranational organizations, many tax authorities are building sophisticated data-gathering platforms that enable matching and sharing of taxpayer data.

Companies will face risks and exposure if their people, processes and systems are dated or out of sync with government requirements and expectations. Audit committees should confirm that tax departments are equipped to operate in the new era of digital tax by embracing enterprise initiatives and transformations that facilitate enhanced data management.

Questions to consider

10. How is the company informing itself and the audit committee on tax policy changes and opportunities?
11. Does the company have a presence in any of the countries currently under EU State aid investigation?
12. Is there a plan in place to handle potential controversies that may arise as a result of the new country-by-country reporting initiatives and the additional transparency involved, including potential public disclosure?
13. Has management modeled the impact of the House Republicans’ tax Blueprint, and is it doing all it can at year-end to maximize deductions?
14. Does the company have a strong global vision and strategy for managing tax risk and tax controversy? Has the strategy been communicated to the audit committee and full board?
15. Has management shifted focus from traditional compliance activities to real-time digital audit readiness activities – including considering changing technologies, processes and people to support this shift?

Reference library

- Election 2016: Trump wins presidency, Republicans hold Congress
- Final US country-by-country regulations – is your company ready to report?
- Global Tax Policy and Controversy Briefing, Issue 18, October 2016
- Running the numbers – how data analytics is transforming tax administration
- Tax risk and the audit committee

Many of the referenced documents are located on EY’s AccountingLink. First-time visitors will be prompted to complete a brief registration form to access the AccountingLink site.
Regulatory update

Background

2016 has been marked by significant regulatory activity around key audit issues, enhanced transparency of the audit process and the audit committee’s oversight activities. Consistent with the prior years, there continues to be a focus on enhancing disclosure effectiveness and a noticeable increase in SEC enforcement activities. Audit committees must stay abreast of these activities and oversee compliance by management and the external auditor.

Further discussion

Public Company Accounting Oversight Board (PCAOB) developments

In November 2016, the PCAOB announced the approval of the 2017 budget and its 2016–2020 strategic plan. The strategic plan focuses on streamlining efforts and includes initiatives relating to inspecting firms located in China, evaluating audit quality indicators, monitoring independence and assessing the business models of registered firms. Priority projects for 2017 include (1) consolidating and strengthening the PCAOB’s economic and risk analysis program, (2) improving the standard setting program, and (3) developing an inspections approach to be applied to broker-dealer audits. All could affect future audits and the relationship between the external auditor and the audit committee. As a result, audit committees should keep track of these new developments and consider participating in the standard-setting process.

US initiatives to increase transparency of the audit process

Audit committees should monitor pending proposals and final rules addressing the transparency of the audit process:

- Supervision of audits involving other auditors. This PCAOB proposal would strengthen existing requirements and impose a more uniform approach to a lead auditor’s supervision of other auditors.

- Enhanced auditor report. This PCAOB proposal would expand the auditor’s report to include a discussion of critical audit matters (CAMs) and disclosure of auditor tenure.

- Audit partner transparency. In May 2016, the SEC approved the PCAOB’s final standard requiring audit firms to file a new form with the PCAOB, which it will post online, disclosing the name of the lead audit partner and providing information about other accounting firms participating in the audit.

Enhancing audit committee reporting

The growth in audit committee transparency continued in 2016, with audit committees voluntarily enhancing disclosures about how they carry out their oversight responsibilities. Audit committees should evaluate whether their report and other disclosures should be enhanced.

Disclosure effectiveness related initiatives

Regulators and standard setters are increasingly focused on making business and financial disclosures more effective. In addition to considering potential improvements to disclosure rules, the SEC staff has called on companies to proactively enhance their disclosures by reducing repetition, focusing on material information and eliminating outdated and immaterial information. Additionally, the SEC issued releases on modernizing Regulations S-X and S-K seeking input on how it might improve the delivery of material information to investors and remove duplicative or outdated disclosure requirements. The SEC is also seeking comment on how to enhance disclosures usually included in the proxy statement, including those on executive compensation, beneficial security holders, related parties and other corporate governance matters addressed
Questions to consider

16. Do the audit committee and management understand emerging regulatory requirements, and is management prepared to meet the additional disclosure and compliance requirements?

17. What steps should the audit committee taken to increase transparency around its oversight of the audit relationship?

18. Does the company have a plan to enhance its disclosure effectiveness with a clear timeline and the required project management support?

19. Is management monitoring the SEC’s rulemaking agenda and how could proposed rules affect the company?

Reference library

- Audit committee reporting to shareholders in 2016
- Four takeaways from proxy season 2016
- SEC in Focus – October 2016

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SEC enforcement activities

SEC enforcement activities have noticeably increased in recent years, driven in part by the Division of Enforcement’s creation of a financial reporting and auditing task force and its use of data analytics.

Possible causes of problems at issuers noted in SEC enforcement actions include poor tone at the top, pressure to meet financial targets/earnings management, and growth outpacing infrastructure. The accounting and auditing enforcement actions have covered topics ranging from revenue recognition (e.g., percentage of completion, accelerated or false revenues, bill and hold arrangements) to disclosure failures. The SEC also has filed enforcement actions against auditors for lack of professional skepticism, overreliance on management representations, failure to obtain sufficient audit evidence and having insufficient documentation. 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 non-compliance with laws and regulations.
Risk management

Background

Organizations today are challenged with managing a rapidly changing risk landscape. In response, audit committees must take an even more proactive role in understanding the company’s risk appetite, risk culture and risk management policies and procedures. More than ever, they must understand the evolving risks their organizations face as they oversee responses to existing and emerging risks. In exercising their oversight duties, audit committees must determine whether management maintains effective internal controls and systems designed to prevent and detect potential legal and regulatory violations and address emerging risks in this volatile environment.

Enterprise risk management (ERM)

Disruptive forces such as economic volatility, competitor innovation, regulatory changes, cyber threats and technological shifts are rapidly changing the risk landscape, forcing audit committees to challenge their organizations to rethink how they manage and respond to risks and evaluate risk-return tradeoffs to drive value creation.

The next generation of enterprise risk management and oversight is more proactive, simplified and integrated, with a heightened focus on strategic, preventable and external risks. Boards can enhance ERM efforts by strengthening the alignment of risk and business objectives and determining that organizations have clear risk ownership, processes and operating models to provide a comprehensive view of risk. Audit committees should confirm that organizations are positioned to better enable the three lines of defense model2 to sustain solutions, focus on high-value risk areas and leverage risk management programs and technology platforms to maximize ERM efficiency and effectiveness. Additionally, audit committees should revisit the internal audit mandate to assess ERM alignment and the right balance of cost, risk and value.

Navigating the dynamic geopolitical, economic and political risk landscape

Prior to the 2016 election in the US, EY’s October Capital Confidence Barometer found that 29% of global senior executives viewed political instability as the greatest economic risk to their core business over the next 6 to 12 months. Leading audit committees will be vigilant in questioning whether and how the political and regulatory environment may heighten company risks and offer opportunities for growth.

The new US administration’s priority focus areas likely will include tax policy and reform, health care and Affordable Care Act reform, increased infrastructure spending, energy policy, global trade agreements, immigration control and financial regulatory reform. The president-elect has outlined an ambitious agenda for early 2017, and audit committees should question the implications to the registrant’s financial reporting, corporate disclosures, risk management activities and compliance.

Corruption

Global commitments to combating corruption and enhanced cooperation and enforcement by law enforcement agencies have increased the pressure on companies to mitigate fraud, bribery and corruption risks. With some global executives willing to justify unethical activity, audit committees need to continuously assess their ability to robustly oversee fraud, bribery and corruption risk.

Such actions take particular importance as companies expand their business footprint into emerging markets such as Africa, Brazil, China, India and Eastern Europe, where they may be exposed to heightened risks, and as companies continue to grow via record M&A activity. EY’s 2016 Global Fraud Survey found that respondents generally are not yet taking steps to identify and
Questions to consider

20. Has the organization sufficiently identified and assessed the external risk landscape, and does it have the appropriate mitigation and incident response plans in place?

21. Is the board applying a nuanced approach to risk management to realize opportunities associated with strategic risk-taking while minimizing exposure to preventable and external risks?

22. How integrated is internal audit with the organization’s strategic management processes and how is internal audit providing a “risk lens” to management actions and decisions?

23. Has the company’s risk assessment changed in response to the changing geopolitical landscape – what risks emerge, and what opportunities exist? What are the unintended consequences of the various shifts?

24. How proactive and agile is the company’s approach to assessing and addressing risk, including with regard to its use of data, analytics and technological platforms?

25. Is the organization’s cybersecurity strategy anchored to business drivers, and is the organization’s cybersecurity talent strategy appropriately aligned?

26. What are the organization’s current and future supply and demand forecasts for the cybersecurity workforce and are there gaps in specific skills and roles?

Reference library

- 2016-insights-and-questions-for-the-board
- Global information security survey 2016
- Global fraud survey 2016
- Maximizing value from your lines of defense

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mitigate key corruption and other risks before entering into local joint ventures, partnerships and other business relationships. To minimize such risks, audit committees should confirm that management is adequately resourcing compliance and investigative functions and is undertaking regular fraud risk assessments. Data is also becoming an increasingly important monitoring tool, and audit committees should determine that internal audit is appropriately leveraging data-driven indicators.

Cyber resilience

Organizations have learned to defend themselves against, and respond better to, cybersecurity threats, moving from rudimentary measures and ad hoc responses to sophisticated, robust and formal processes. Boards and audit committees should continue to encourage organizations to: (1) sharpen cyber senses to predict and detect cyber threats; (2) upgrade resistance mechanisms to strengthen the corporate shield by establishing three lines of defense; and (3) improve resilience to bring an organization back to business as usual in the fastest way possible.

As threats continue to evolve and cyber criminals become more sophisticated, boards and audit committees must address how organizations manage another variable in their defense: cybersecurity talent. Having the talent with the right capabilities to analyze data, monitor systems and respond to anomalies in order to disrupt an attack is the lynchpin in an organization’s defense. Technology and processes can be inadequate without the appropriate talent to implement and operationalize cybersecurity measures. The board and audit committee can promote this objective by making cyber talent development a strategic imperative, first by applying a risk-based lens to cybersecurity and then aligning the organization’s talent management approach accordingly.
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The Lines of Defense (LOD) model has been cited extensively as an effective model to use for risk management and provides a simple and effective way to enhance communications on risk management and control by clarifying roles and duties. The three lines of defense include:

- **First line (operations and business units):** This group comprises the line management directly responsible for identifying and managing risks. This group considers risk management to be a crucial element of its everyday job.

- **Second line (management assurance):** This group is responsible for ongoing monitoring of the design and operation of controls in the first line, as well advising and facilitating risk management activities.

- **Third line (independent assurance):** The groups responsible for independent assurance over managing of risks. Internal Audit (IA) typically plays the leading role.
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