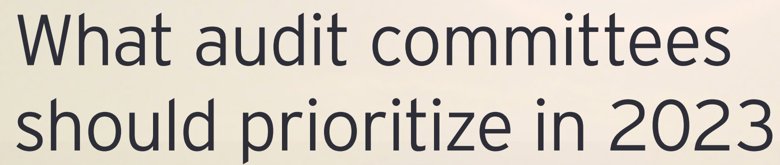
EY Center for Board Matters

What audit committees should prioritize in 2023



What audit committees should prioritize in 2023

This edition summarizes key considerations for audit committees during the 2022 year-end audit cycle and beyond. With the changing risk landscape, the audit committee's role continues to grow more demanding and complex amid the uncertain and dynamic business environment. This report will assist audit committees to proactively address developments in risk management, financial reporting, tax and the regulatory landscape.

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What audit committees should prioritize in 2023

Risk management

Rampant inflation fears, geopolitical tensions and the shadow of the COVID-19 pandemic are the critical threats occupying the minds of CEOs, boards and audit committees. A recent EY CEO survey indicates that, despite the multiple headwinds, many CEOs remain focused on building long-term optionality, resilience and value.

Leading companies are holding firm on transformational investment plans — or formulating new strategies to navigate the new complexity. This includes reframing the company's strategy; reimagining its portfolio, global operations and footprint; and reinventing its ecosystems. Against this backdrop, boards and audit committees are revisiting risk management practices to make sure that risks are managed effectively across the organization, and building more resiliency and overall preparedness to respond and manage these headwinds going into 2023.

Addressing top concerns: unconstrained inflation, ongoing pandemic effects, and geopolitical uncertainty

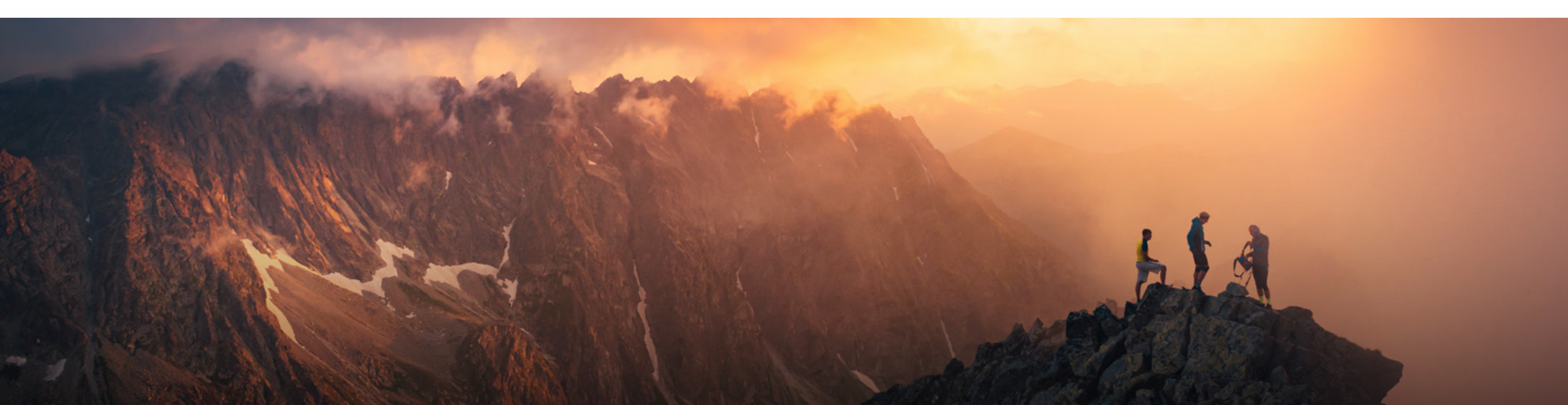
Global economic activity is slowing at a faster-than-anticipated pace, with elevated inflation and surging interest rates leading to increased distress among households and severe constraints for businesses. As organizations prepare to address questions from analysts, investors, regulators and other critical stakeholders on topics such as customer demand, liquidity, supply chain stability and capital allocation, they will need to re-examine their processes for risk identification and assessment to ensure that they have a holistic view of interrelated risks and better understand the related implications. Leading organizations are performing risk assessments more frequently (e.g., quarterly) and leveraging real-time data to better understand their risks and related exposures, including how those exposures are changing quarter over quarter.

While the underlying drivers of surging inflation vary by geography and industry, most companies are seeing major or extreme input price increases across all measures, from labor to raw materials. To combat and mitigate these risks, leading organizations are reshaping their operations, which includes building sustainability and environmental, social and governance (ESG) as a core aspect of all products and services to engage customers; boosting customer loyalty using technology to optimize product suite or services; and adopting new pricing constructs or innovative pricing models to improve profitability and performance to protect margins.

Geopolitical tensions have had a direct impact on accelerating input prices and inflation and are also featuring prominently in risks assessments. The war in Ukraine has increased commodity prices and created yet more supply constraints as well as inflationary pressures. National security concerns, as well as other public policy considerations, could also impact whether and how companies in regulated industries are able to transact business. As a result, board agendas are expanding to include discussions around reconfigurations of supply chains and re-evaluations of global operations and footprint, including potentially exiting businesses in certain markets and stopping planned investments.

Leading organizations are preparing and planning for these unknown risks and developing contingency plans for different scenarios. This begins by identifying the most relevant risks for their business and the factors that will determine whether that risk materializes. With insight, companies can establish key risk indicators to monitor whether a particular risk is more or less likely to arise and develop relevant mitigation measures.

Audit committees are also spending more time discussing resiliency and using scenario planning (rather than forecasting) to bolster such efforts. Leading organizations are using simulations, triggers and multi-faceted scenarios, including exercising more rigor in developing base plans and alternative scenarios.



Evolving cybersecurity governance

Cybersecurity risks continues to multiply and accelerate, marked this year by potential threats tied to the war in Ukraine. Meanwhile, more guidance on cyber oversight and disclosure is here or on its way from the Securities and Exchange Commission (SEC or Commission), which proposed new rules earlier in 2022, and from Congress, which recently passed far reaching legislation.

In our latest analysis of cyber-related disclosures in the proxy statements and Form 10-K filings of Fortune 100 companies, we found that companies continue to increase disclosures in certain categories of cybersecurity risk and oversight. However, there appears to be a gap between disclosures around material cybersecurity incidents, including the depth of the disclosures, as compared with the number and scale of cyber incidents noted in the news media and other third-party reports. The SEC's proposed rules on cybersecurity will have a significant impact on future disclosures — accordingly, audit committees should closely monitor this area and encourage management to proactively strengthen its disclosures.

Based on insights gained through engagements with directors, we have identified the following 10 leading practices to help boards oversee cyber risk:

- Elevate the tone. Establish cybersecurity as a key consideration in all board matters.
- Stay diligent. Address new issues and threats stemming from remote work and the expansion of digital transformation. And remember that every employee needs to be diligent, too — 82% of breaches involve a human element, according to Verizon's 2022 Data Breach Incident Report, issued in late May.
- Determine value at risk. Reconcile value at risk in dollar terms against the board's risk tolerance, including the efficacy of cyber insurance coverage.
- Leverage new analytical tools. Such tools inform the board of cyber risks ranging from high-likelihood, low-impact events to low-likelihood, high-impact events (i.e., a black swan event).
- Embed security from the start. Embrace a "trust by design" philosophy when designing new technology, products and business arrangements.
- Independently assess the organization's cyber program. Obtain a rigorous third party assessment of your cyber risk management program (CRMP).
- Evaluate third-party risk. Understand management's processes to identify, assess and oversee the risk associated with service providers and third parties involved in the organization's supply chain. Supply chains were responsible for 62% of system intrusion incidents in 2021, according to Verizon's 2022 Data Breach Incident Report.
- Test response and recovery. Enhance enterprise resilience by conducting rigorous simulations and arranging protocols with third-party specialists before a crisis.
- Understand escalation protocols. Have a defined communication plan for when the board should be notified, including incidents involving ransomware.
- Monitor evolving practices and the regulatory and public policy landscape. Stay attuned to evolving oversight practices, disclosures, reporting structures and metrics.

Continued focus on talent strategies and workforce issues

Post-COVID-19, the ongoing transformation of the traditional employer-employee relationship and the elevation of corporate culture as a key strategic enabler continue to carry new and significant risks. Talent shortages and workforce-related issues are indicative that the impact of the Great Resignation will persist and that organizations will continue to struggle to fill talent requirements to support achieving their strategies and organizational objectives. Further, transformative technologies and disruptive innovations will require organizations to upskill and re-skill their workforces and attract and retain top talent.

Additionally, there is growing focus on the employee experience and employee engagement. Companies must respond thoughtfully to the new set of employee expectations and incorporate these expectations into future talent strategies and programs. With this ongoing race for talent, boards are focusing on scrutinizing the company's efforts and strategies on attracting and retaining top talent and more closely monitoring culture and human capital metrics.

Transformative technologies and disruptive innovations will require organizations to upskill and re-skill their workforces and attract and retain top talent.

Evolving risk management programs to incorporate technology-enabled risk management

Traditional enterprise risk management practices, which often include rules-based monitoring techniques and subjective scenario-based approaches to identify, detect and analyze risks, are no longer optimal in this risk environment. Some common problems include a poorly functioning intelligence process technology that does not provide timely actionable insights but produces stale, backward-looking risk reporting. In addition, manual risk processes are often seen as an intrusion into business operations, slowing the pace of business itself.

With ever-increasing pressure to do more with less, companies are having to find new ways to accelerate the modernization and digitalization of their risk management processes. This means organizations are transforming their risk management approach by embedding data science and technologies (such as analytics, artificial intelligence, robotic process automation and machine learning) across the entire risk management process, from identification to assessment to mitigation to monitoring. We highlight some trends and ways that organizations are leveraging data and technology to enable and enhance integrated risk management efforts:

- Turning to integrated risk management (IRM) to enable greater visibility, coordination and management of risk across the enterprise. IRM treats risk and compliance as an enterprise-wide responsibility by managing risk across the enterprise, integrating activities and implementing processes to enable greater visibility and give management better information for decision-making.
- Leveraging technology such as artificial intelligence to mine the past patterns and elicit specific predictions about the future. Utilizing data science in such a manner allows for more objective evidence-based and deep analytical findings to allow for enhanced decision-making.
- Using digital twins (virtual representations that serve as the real-time digital counterpart of a physical object or control) for simulations to enhance traceability throughout the supply chain and enable more transparency into potential risk interdependencies.
- Using tech-enabled analytics to better understand cost drivers and address inflation risks; sophisticated analytics may help in developing a nuanced understanding of risk exposures and pricing impacts.

Integrated risk management platforms and cloud infrastructure are also enabling teams to analyze risk trends more easily and providing the data storage capacity and analytics firepower needed to conduct horizon scanning, scenario planning and stress testing based on multiple variables. Boards and audit committees are seeking this type of analysis, and they are looking for teams to effectively detect weak signals of atypical and distant threats before they materialize into a major risk.

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

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Transforming risk, compliance and internal audit: key trends and observations

Risk and compliance functions have been slow to transform from a compliance orientation to differentiating as strategic advisors. The EY 2022 Global Internal Audit and Internal Control Survey Results explores the priorities of internal audit and risk management leaders. We've noted some highlights from this report along with other market observations:

- More companies are leveraging new ways of compliance management and reporting that are powered by data analytics and automation as it provides more efficient and effective internal control oversight. Only 30% of respondents currently perform data analytics in the audit cycle; however, our survey results show that it is the top opportunity to enhance their compliance or risk management function.
- Nearly 40% of survey respondents are actively performing a separate emerging risk assessment, and an additional 15% plan to do so within the next three years.
- Risk assessments are becoming more dynamic to minimize audit and compliance fatigue: Using robust data analytics, risk analysis is becoming more proactive by detecting imperceptible process failures, flagging lapses and marking their occurrences to avert future errors. Digital tools such as scoping accelerators enable companies to zero in on material entities and financial statement line items, business functions and corresponding IT systems.
- The dynamic regulatory landscape around the globe is putting performance pressure on many organizations. These organizations in turn look to their internal audit and risk management executives to stay abreast and comply with the ever-changing requirements (e.g., the SEC's cyber proposal). As more of these types of regulations are rolled out around the world, internal audit teams can provide value by performing capabilities or gap assessments to evaluate their organization's current posture relative to the proposed regulatory requirements.
- Internal audit and risk functions are expanding hiring practices (such as looking for more digital and technology talent vs. the traditional audit and controls background) and evolving from a traditional internal audit and controls model. Companies are using co-sourcing models to gap fill for specialist talent; rotational models to show employees that internal audit is valued across the business and offers career growth opportunities; and hybrid or work-from-home models to attract and retain talent.
- The downtrend in new audit talent elicits concern for long-term difficulty with recruitment and potential impact on overall audit quality. Leading organizations are developing tailored learning and experience curricula for soft and technical skills to upskill their internal audit function.
- Businesses are reprioritizing the internal audit function as consultatory business advisors, not just assurance providers. This redistribution of resources within internal audit may help retain and obtain talent; however, the internal audit function must be careful to follow its mandate. Convincing business leaders and the board of internal audit's value and increasing resources to the function may ease the tension between assurance and consultancy.

Enhancing integrity and sharpening the focus on fraud and overall compliance

The EY 2022 Global Integrity Report reveals that more companies than ever value corporate integrity and its benefit to reputation and employee retention, although challenges remain. Fifty-five percent of respondents believe that standards of integrity have either stayed the same or worsened over the last 18 months.

Since the pandemic arose, companies have continued to increase training, communication and awareness of integrity issues with their employees. However, the EY survey findings show that organizations are struggling to close the gap between rhetoric and reality (the "say-do" gap), with senior management often overconfident of the effectiveness of corporate integrity programs. Although organizations are investing more in communication and training programs, that messaging alone is not enough to create a culture of integrity. While 60% of board members say that their organization has frequently communicated about the importance of behaving with integrity in the last 18 months, only half that percentage (30%) of employees remember it.

This year's survey examines the challenges experienced by companies when building a culture of deep integrity. With the growing demands and expectations around transparency and ESG, the report emphasizes the importance of creating a culture that supports ethical decision-making. In fact, 42% of surveyed board members indicated that unethical behavior in senior or high performers is tolerated in their organization (up from 34% in 2020).

Key actions boards and audit committees can take to bolster integrity include:

- Verify that the organization is performing fraud and corruption risk assessments to protect the organization. Specifically, these assessments should be taken seriously from the top down, be data-enabled and be regularly and robustly performed, with any gaps or weaknesses exposed and rectified.
- Recognize that systems and processes don't commit fraud, humans do. The best compliance frameworks can be breached if there isn't a culture of doing the right thing, which makes building a strong integrity culture as important as the control environment. In addition to emphasizing a strong integrity culture, boards and audit committees should encourage companies to focus on tech-driven and data-centric ways (e.g., forensic technology solutions to identify hidden risks, benchmarking to understand outliers) to measure integrity culture and build the right controls and processes.
- Treat the growth in data volumes as an opportunity to aid the combat of fraud, not as a threat. Evaluate whether the organization is using its own data to detect irregular behavior and guide its response to preventing and investigating it. Determine whether there are ways of collecting data that support the organization's ESG journey and align to the organization's integrity agenda.
- As the survey highlights, the integrity message is slowly landing and yet appetite for malpractice is growing. Continue the journey of communicating and awareness building by moving from training to educating, so everyone understands the "why" as well as the "what" of business integrity.
- Support whistle-blower processes — validate that employees are given the opportunity to report suspected wrongdoing in good faith and make them feel assured that there is protection against retaliation.

Lastly, US Deputy Attorney General Lisa Monaco issued a memo in September 2022 announcing changes to the Department of Justice's corporate criminal enforcement policies. This memo shines a light on corporate accountability and the importance of implementing strong compliance programs and a culture of integrity and ethics. Boards and audit committees should understand the implications of the Monaco memo, including revisiting their organization's compliance program to verify whether it is designed and functioning effectively. Additionally, boards may want to understand how the memo may signal potential changes in the corporate enforcement landscape.

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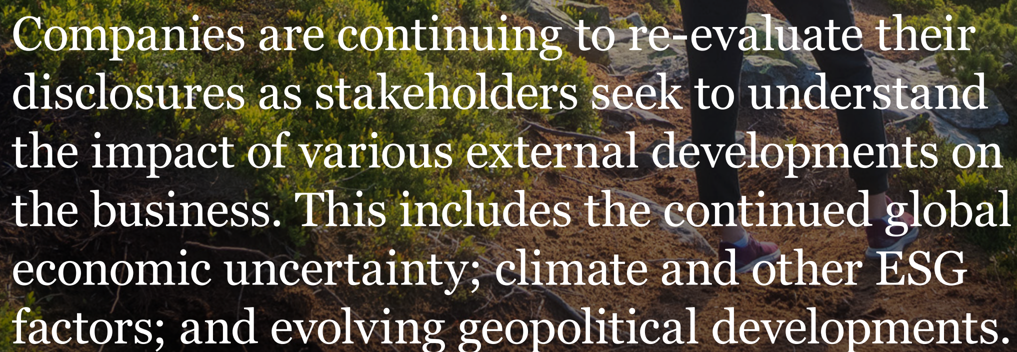
Financial reporting



Companies are continuing to re-evaluate their disclosures as stakeholders seek to understand the impact of various external developments on the business. This includes the continued global economic uncertainty; climate and other ESG factors; and evolving geopolitical developments.

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

Accounting and reporting considerations for macroeconomic factors

Organizations continue to be affected by macroeconomic factors, such as inflation, rising interest rates, supply chain disruptions and stock market volatility, as well as the war in Ukraine and its ripple effects. We anticipate that audit committees will continue to evaluate these evolving impacts and changes in the business environment on their financial reporting processes. Key considerations may include the following:

- Continue to assess changes in the business, trends or uncertainties and the implications for financial reporting. This includes determining how inflation and supply chain issues may be affecting cash flow projections used in prospective financial information and what discount rate is used to discount those cash flows.
- Revisit disclosures included in SEC filings, such as risk factors, critical accounting estimates, liquidity, and capital resources to address certain risk concentrations (e.g., customer, supplier, geographic) and other known trends, events, and risks and uncertainties that have had or are reasonably expected to have a material effect on the business. In addition, make sure risk factor disclosures and management's discussion and analysis (MD&A) include sufficient details about the macroeconomic factors. The SEC staff has been asking companies to discuss these effects in more detail, including the steps they are taking to mitigate inflationary pressures, and we expect the staff to ask more questions in its reviews of year-end filings. The SEC staff is also likely to ask about any non-GAAP measures a company uses in describing the effects of macroeconomic factors or the COVID-19 pandemic.
- Given the economic headwinds, companies may be re-evaluating their business strategy, including disposals of certain businesses. Disposing of a component of the entity may require presentation of the disposal as a discontinued operation, which requires judgement to determine whether the applicable criteria are met.
- Companies may also be considering derivative transactions, such as interest rate swaps or purchased interest rate caps, to mitigate the potential negative effects of rising interest rates on their cash flows and financial results. Companies that are contemplating applying hedge accounting to these transactions need to understand all of the specific requirements in Accounting Standards Codification (ASC) 815, because the guidance is fairly prescriptive and may not always be intuitive.
- Companies experiencing liquidity issues may be at risk of violating debt covenants, which could affect debt classification. Debt that becomes callable upon a covenant violation at the balance sheet date (or before the issuance of financial statements) is classified as a current liability unless (1) the creditor has waived or lost the right to demand repayment for more than one year (or operating cycle, if longer) from the balance sheet date or (2) it is probable that the violation will be cured within a contractual grace period.

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- Throughout the year, many companies had to consider whether indicators of impairment existed for intangible assets and goodwill, and in some cases, perform an interim impairment test. Those considerations need to be updated for events and changes in circumstances in the fourth quarter in connection with companies' annual or interim impairment assessments. Companies also should update their assessments of whether impairment indicators exist for long-lived assets. In addition, they should also make sure they are using consistent assumptions in each of their analyses and public statements that they are making elsewhere (e.g., in management's discussion and analysis).
- Companies with financing receivables (e.g., trade accounts receivable, loans) and contract assets should consider the guidance in ASC 326 (or ASC 310 if they haven't adopted ASC 326) to evaluate whether and how inflation, rising interest rates, supply chain issues, recession risks or other economic conditions affect the collectibility of their financing receivables and contract assets. Given the uncertain economic outlook, companies that are applying ASC 326 also should assess whether the assets they are required to pool to assess credit losses continue to display similar risk characteristics and determine whether they need to revise their pools or perform an individual assessment of expected credit losses.
- Companies applying ASC 326 also need to consider the current economic environment when developing reasonable and supportable forecasts of future economic conditions for use in estimating expected credit losses. Companies should consider highlighting the uncertainty and any significant inputs or assumptions in their qualitative and quantitative disclosures about credit risk and the allowance for credit losses.

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

Companies should continue to update their disclosures and consider the financial statement effects of the current market conditions.

Other disclosure reminders

FASB requires disclosures about supplier finance program obligations

The Financial Accounting Standards Board (FASB) issued final guidance requiring entities that use supplier finance programs in connection with the purchase of goods and services to disclose the key terms of the programs and information about their obligations that are outstanding at the end of the reporting period, including a rollforward of those obligations.

The guidance is intended to address stakeholder requests for more transparency about the use of supplier finance programs and their effect on entities' working capital, liquidity and cash flows.

Entities are required to apply the guidance retrospectively to all periods in which a balance sheet is presented, except for the rollforward requirement, which is applied prospectively. The guidance is effective for all entities for fiscal years beginning after 15 December 2022, including interim periods in those fiscal years, except for the rollforward requirement, which is effective for fiscal years beginning after 15 December 2023. Early adoption is permitted.

Government assistance disclosures required in year-end reporting

All business entities are required to provide disclosures this year about certain assistance it receives from a government under Accounting Standards Update (ASU) 2021-10. The requirements apply to transactions with a government that are accounted for by analogizing to a grant or contribution model, such as IAS 20 or ASC 958-605. They don't apply to transactions with a government that are accounted for in accordance with other existing US GAAP topics (e.g., ASC 450, ASC 606, ASC 740).

The required disclosures include the nature of the transaction, the entity's related accounting policy, the financial statement line items affected, and the amounts reflected in the current-period financial statements, as well as any significant terms and conditions. An entity that omits any of this information because it is legally prohibited from being disclosed needs to include a statement to that effect.

What we're seeing in SEC comment letter trends

The following chart summarizes the top 10 most frequent comment areas in the current and previous years:

	Ranking 12 months ended June 30*		Comment area received as a percentage of registrants receiving comment letters	Average letters per registrant***
Comment area	**2022**	**2021**	**2022**	**2022**
Non-GAAP financial measures	1	1	44%	1.4
Management's discussion and analysis (MD&A)**	2	2	36%	1.1
Segment reporting	3	3	15%	1.2
Revenue recognition	4	4	11%	1.2
Fair value measurements	5	5	9%	1.1
Climate-related disclosures	6	n/a****	8%	2.2
Inventory and cost of sales	7	9	7%	1.3
Signatures/exhibits/agreements	8	6	7%	1.0
Goodwill and intangible assets	9	7	6%	1.1
Acquisitions and business combinations	10	n/a****	6%	1.2

* These rankings are based on topics assigned by research firm Audit Analytics for SEC comment letters issued to registrants with a market capitalization of $75 million or more on Forms 10-K and 10-Q from 1 July 2021 through 30 June 2022 and the comparable period, respectively. In some cases, individual SEC staff comments are assigned to multiple topics if the same comment covers multiple accounting or disclosure areas.

** For the year ended 30 June 2022, this category includes comments on MD&A topics, excluding climate-related disclosure matters, in order of frequency: (1) results of operations (67%), (2) liquidity matters (13%), (3) critical accounting policies and estimates (11%), and (4) business overview (9%). Many companies received MD&A comments on more than one MD&A topic.

*** This represents the number of comment letters (or rounds of comments) that were issued by the SEC staff for the given comment area during the 12 months ended 30 June 2022.

**** This topic was not among the top 10 in 2021.

Climate-related disclosures moved into the top 10 for the first time, and we expect the SEC staff to continue to scrutinize these disclosures, even as the Commission works to finalize new rules to require more extensive disclosures in the future. The nature of the comments issued were consistent with the sample letter the SEC staff previously issued on this topic. On average, the comments on climate-related disclosures also required more rounds of comments to resolve than comments on other topics on our top 10 list.

The SEC staff has also been asking registrants about the effects of macroeconomic factors such as inflation, rising interest rates, the economic fallout of the war in Ukraine, and supply chain issues. Given the persistence of inflation and the expectation that interest rates will continue to rise, we expect to see more SEC staff comments on macroeconomic factors. Registrants should carefully evaluate how economic conditions may affect their business and provide disclosures related to these matters in sufficient detail.

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Climate-related disclosures moved into the top 10 for the first time, and we expect the SEC staff to continue to scrutinize these disclosures, even as the Commission works to finalize new rules to require more extensive disclosures in the future.

In our review of SEC staff comment letters on periodic reports, we also found that the volume of letters increased 10% from the previous year, reversing the downward trend of the past 11 years. However, the SEC staff still issued fewer comment letters than it did in 2020, and therefore, we have not seen a return to prior levels.

Looking ahead, we expect that the SEC staff will continue to focus on many of the same topics in the top 10 list and expand its comments related to:

- Climate-related disclosures based on the Commission's 2010 guidance in advance of any finalized rule
- The effects of macroeconomic factors, including the impact of inflation, rising interest rates and supply chain issues
- Application of the amended guidance in Regulation S-K related to MD&A
- The materiality evaluation of an error in previously issued financial statements, and how the error was corrected, such as challenging registrants on the overreliance on qualitative factors when concluding that a quantitatively significant error is immaterial

In the coming year, we also expect the SEC staff to focus on:

- Board leadership structure and risk oversight disclosures
- Cybersecurity-related disclosures (e.g., risk factors) based on the Commission's 2018 guidance on public company cybersecurity disclosures in advance of any finalized rule.
- The new pay-vs.-performance rules that will be effective for the proxy and information statements filed in early 2023

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

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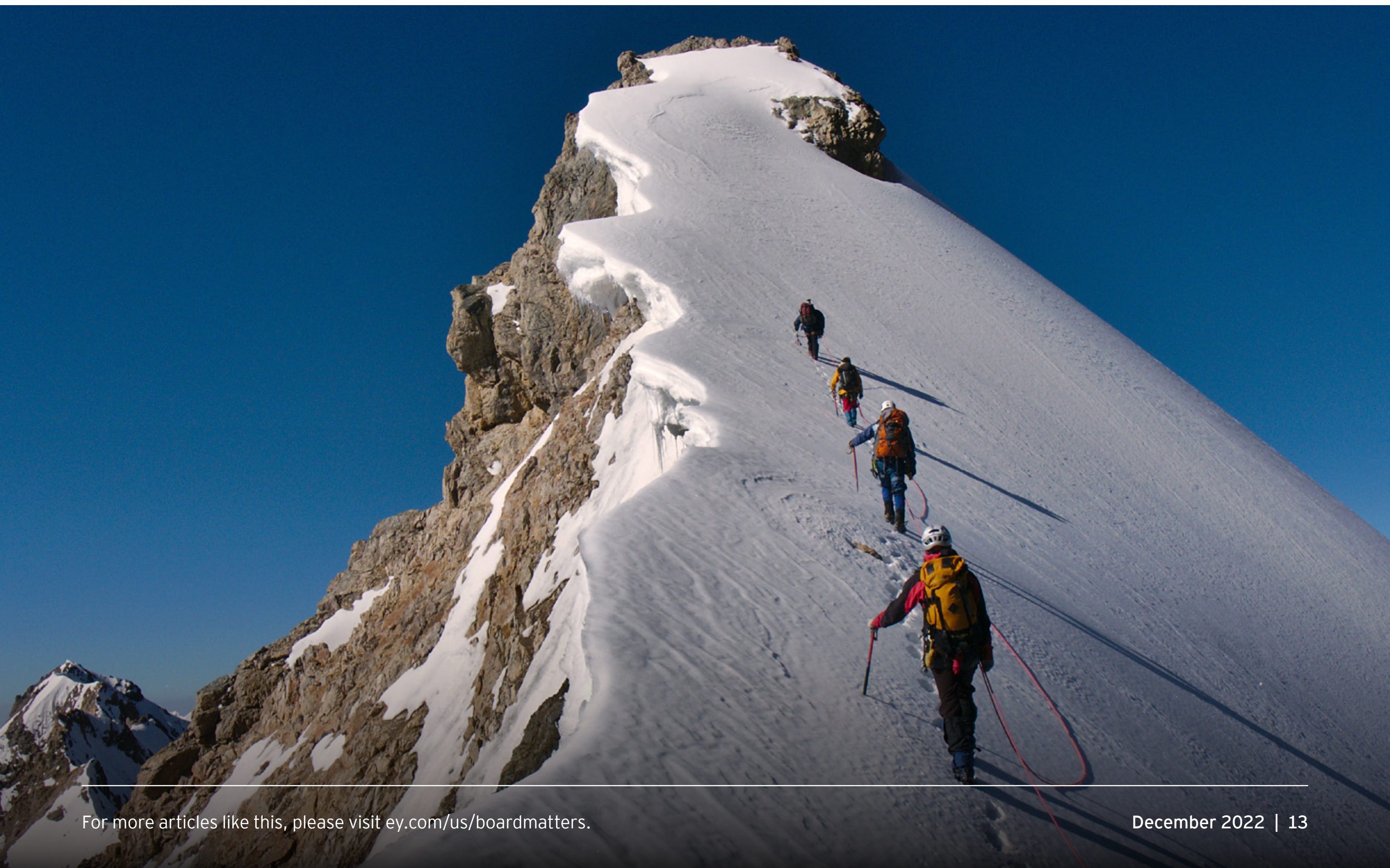

Restatement trends

Audit Analytics (AA) released its report *2021 Financial Restatements: a twenty one year review*. We've highlighted and excerpted some of the notable trends and issues included in the report below:

- The number of restatements filed increased significantly to 1,470 (which represents a 289% increase in total restatements), primarily due to special purpose acquisition company (SPAC) restatements. In response to SEC guidance on accounting for warrants and redeemable shares, many SPACs had to restate financials.
- SPAC restatements had a significant impact on the historical trend analysis for financial statements and contributed to 77% of the restatements. Excluding SPAC restatements, there was a 10% year-over-year decrease.
- The top 10 accounting issues implicated in restatements disclosed in 2021 are noted in the chart below. While revenue recognition had been the top issue in each of the past three years, debt and equity was 2021's top issue, both including and excluding SPAC restatements.

Top 10 accounting issues of 2021

			Excluding SPAC-centered restatements (redeemable shares/warrants)	
Restatement issue	**Citations**	**Frequency**	**Citations**	**Frequency**
1. Debt and equity securities	**1,182**	**80.4%**	**65**	**19.1%**
2. Revenue recognition	**41**	**2.8%**	**41**	**12.0%**
3. Liabilities and accruals	**41**	**2.8%**	**40**	**11.7%**
4. Expenses	**39**	**2.7%**	**37**	**10.9%**
5. Taxes	**30**	**2.0%**	**30**	**8.8%**
6. Cash flows	**25**	**1.7%**	**25**	**7.3%**
7. Share-based compensation	**25**	**1.7%**	**24**	**7.0%**
8. Acquisitions and divestitures	**25**	**1.7%**	**24**	**7.0%**
9. Inventories	**23**	**1.6%**	**23**	**6.7%**
10. Asset valuations	**23**	**1.6%**	**22**	**6.5%**

See also the *Regulatory developments* section for additional commentary regarding requirements for the clawback of incentive-based compensation due to an accounting restatement.

SOX 404 disclosure trends

AA also released its annual report on Sarbanes Oxley Act (SOX) Section 404 reporting: *SOX 404 Disclosures: An Eighteen-year review*, which summarizes the trends in SOX 404 disclosures. Per this report, there was an increase in adverse internal control over financial reporting (ICFR) reports in 2021 — adverse auditor assessments of ICFR increased to 5.8% and adverse management reports increased to 23.7%. We've highlighted some of the notable trends and issues included in the report below:

Management reports

2021 top 5 accounting issues cited in adverse ICFR assessments

Issue	% of disclosures	No. of disclosures
1. Debt and warrants	**12.7%**	**202**
2. Revenue recognition	**6.5%**	**104**
3. Accounts receivable, investments and cash	**6.1%**	**98**
4. Tax expenses	**3.9%**	**62**
5. Expense recording	**2.7%**	**43**

Auditor attestations

2021 top 5 accounting issues cited in adverse ICFR assessments

Issue	% of disclosures	No. of disclosures
1. Revenue recognition	**20.8%**	**41**
2. Tax expenses	**13.2%**	**26**
3. Accounts receivable, investments and cash	**10.7%**	**21**
4. Acquisition, mergers	**10.2%**	**20**
5. Property, plant and equipment, intangibles	**9.1%**	**18**

Management reports

2021 top 5 internal control issues cited in adverse ICFR assessments

Issue	% of disclosures	No. of disclosures
1. Accounting personnel resources	**71.5%**	**1,140**
2. Segregation of duties (personnel)	**58.4%**	**931**
3. Inadequate disclosure controls	**25.8%**	**412**
4. Non-routine transaction control issues	**20.0%**	**319**
5. Information technology	**18.2%**	**290**

Auditor attestations

2021 top 5 internal control issues cited in adverse ICFR assessments

Issue	% of disclosures	No. of disclosures
1. Accounting personnel resources	**48.7%**	**96**
2. Information technology	**44.2%**	**87**
3. Segregation of duties (personnel)	**34.5%**	**68**
4. Inadequate disclosure controls	**23.9%**	**47**
5. Material year-end adjustments	**14.7%**	**29**

The increases in ineffective ICFR in 2021 appear to be driven by recruiting and retention of qualified accounting personnel along with the related challenge of maintaining segregation of duties due to staffing shortages, causing a negative impact on control effectiveness. Additionally, an increase in the number of new reporting companies driven by companies going public through SPAC mergers may have also triggered these increases.

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

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What audit committees should prioritize in 2023

Tax and other policy-related developments

Opportunities for potential year-end tax legislation, inflationary pressures, a slowing economy and partisan politics provide the backdrop to this year's tax policy outlook.

With guidance anticipated from the U.S. Treasury Department on several tax issues and open questions about future US and global tax policy, boards and audit committees must oversee their organizations' responses to tax changes in real time. They need to closely monitor the tax environment to recognize both potential challenges and opportunities and to remain agile in the face of uncertainty.

US tax policy outlook

Legislation could still be enacted in the remaining weeks of 2022, and that legislation could include tax changes. Among the possibilities for inclusion are modifying expired Tax Cuts and Jobs Act (TCJA) provisions. These include addressing a change to Section 174 that requires five-year research and development (R&D) amortization rather than expensing; the Section 163(j) interest deduction calculation and the phasedown of bonus depreciation after this year. Other potential tax items that could be included in year-end legislation are bipartisan retirement tax incentives and some non-energy tax extenders. Democrats may push for tax relief for lower-income families as part of year-end negotiations.

In 2023, Democrats will control the US Senate and Republicans will control the House, albeit with razor thin margins. Looking ahead, Republican policymakers might focus on oversight of the Biden administration and efforts to rescind provisions of the Inflation Reduction Act (IRA), along with policy debates on expiring tax provisions from the TCJA. But given the political split between the executive and legislative branches, and the split in Congress, it will be difficult to enact significant legislation unless it is bipartisan.

Recent developments — adjusting to new taxes and incentives

Whatever may happen in the future, businesses need to navigate recently passed tax changes in 2022 legislation. For example, the IRA, enacted in August, contains both new taxes and new tax incentives. Among the tax changes are:

- A new 15% corporate alternative minimum tax (CAMT) based on book income that applies to companies that report over $1 billion in profits to shareholders (based on a three-year average), effective for tax years beginning after 31 December 2022
- A 1% surcharge on corporate stock repurchases
- New tax incentives for accelerating renewable energy, adopting electric vehicle (EV) technology and improving the energy efficiency of buildings and manufacturing

The new CAMT brings added complexity for potentially affected companies, and boards and audit committees will need to make sure management is anticipating and assessing the impact. Companies will first need to determine whether the tax applies to them, which is a complicated analysis, and then if so, how much they should pay, which requires two separate calculations to determine their tax liability. The Treasury Department is expected to issue guidance to provide more detail on when the tax applies, how to calculate it, and the CAMT foreign tax credit. Treasury is also expected to provide guidance on the new tax on stock repurchases.

Also enacted this past August was the CHIPS and Science Act of 2022, which aims to counter foreign competition and build a domestic US supply chain for semiconductor chips. In addition to $52.7 billion in funding for semiconductor manufacturing subsidies, grants and loans, the law includes a 25% investment tax credit for investments in semiconductor manufacturing.

Audit committees should know how management is both preparing for any new tax liability and determining the applicability of new incentives stemming from these legislative changes. Companies should be tracking new compliance obligations, as well as examining their supply chains and expansion plans where applicable, incorporating potential tax obligations and opportunities into future plans.

Many tax items, meanwhile, remain in legislative limbo, making planning more difficult. Several tax provisions enacted as part of the TCJA were enacted with "sunset" and change dates, some of which have already taken effect. Other provisions, commonly known as "tax extenders," have typically been extended for short periods and are sometimes included in year-end bills. Many of these tax extenders, however, were allowed to expire in 2021. As these provisions can affect a wide range of taxpayers, boards and audit committees will want to pay attention to whether they are included in year-end legislation.

State outlook

Federal legislative and tax policy changes can have a ripple effect on state tax policy. While states overall have reported record revenues the past couple of years, federal tax legislation — in combination with inflation, potential economic slowdown and budget shortfalls forecast in the coming years — could potentially lead to future business tax increases in some states. States that were receiving pandemic-related federal aid may experience a "fiscal cliff" when that aid is no longer flowing. Businesses in states with poor fiscal conditions may then face an increased risk of higher taxes, while states with stronger fiscal conditions may enact tax rate reductions and other tax relief in the coming year.

The outcomes of this year's midterm elections will also shape states' tax policy decisions, with new governors in several states, more states under single-party control, and changes to state legislative leadership influencing which tax bills will be considered and passed.

Among the other state taxation trends to monitor are:

- The taxation and regulation of the digital economy, as states explore taxes on digital advertising and newer technologies such as cryptocurrency and non-fungible tokens
- Remote and hybrid work policies, as employees seek flexibility, which may complicate existing state tax reporting requirements and create new payroll tax liabilities for companies
- State responses to federal law changes, with the potential for some states to conform to the federal CAMT, especially those that may need to shore up revenue
- State credits and incentives focused on sustainability, climate change, and the onshoring of manufacturing, production and R&D

Tax compliance and controversy — interconnected and complex

Audit committees should receive a report from management on how the company executed against its internal controls over income taxes for the year, including a report out on the recently completed tax compliance season. The report should review tax positions, data sources, and non-automatic method changes that might be needed for the upcoming year — all of these areas should be documented and put into an actionable plan for future use.

Boards and audit committees also need to be aware of changes in the tax controversy landscape. The IRA allocated nearly $80 billion in new funding for the IRS. Of that $80 billion, more than $45 billion is for enforcement (including the determination and collection of "owed taxes"), more than $25 billion is for operations, nearly $5 billion is for systems modernization and over $3 billion is for customer service. The IRS will staff up across the organization, and the increased enforcement funding will likely increase scrutiny of large corporations and complex partnerships, as well as allowing more opportunities to engage the IRS in pre-filing programs.

> "Audit committees should receive a report from management on how the company executed against its internal controls over income taxes for the year.

Global tax developments — more uncertainty

Global tax policy is also in a period of flux. The Organisation for Economic Co-operation and Development (OECD) continues to encourage countries to adopt its two-pillar approach to reform of the international tax system (Pillars One and Two of its "BEPS 2.0" initiative, including the Global Anti-Base Erosion (GloBE) model rules). With countries around the world beginning to take steps toward action on the Pillar Two global minimum tax, boards should be monitoring and anticipating potential tax changes at the individual country level in relevant jurisdictions.

A proposed provision designed to modify an existing US tax rule (the global intangible low-taxed income (GILTI) rule) to align it more closely with the Pillar Two proposal was not ultimately included in the IRA, and the IRA's CAMT also has significant differences from the Pillar Two design. The prospects for aligning the US system with Pillar Two by enacting further legislation in the United States is uncertain at best given the current political dynamics in Congress.

Globally, it is unclear whether the European Union (EU) will move forward as a single bloc on Pillar Two. France, Germany, Italy, the Netherlands and Spain, five of the largest EU economies, however, have signaled their willingness to implement the Pillar Two global minimum tax unilaterally, even if no agreement is reached among all EU Member States. The GloBE model rules provide effective dates beginning in 2023 and 2024, but many countries have signaled the intention to use effective dates beginning in 2024 and 2025. It is therefore important for businesses to monitor the introduction of Pillar Two rules in each relevant jurisdiction and evaluate the potential impact on their tax positions and on their finance, IT, human resources and treasury departments, noting that, as designed, the enactment in one jurisdiction may result in a minimum tax due on income earned in another jurisdiction.

Regarding Pillar One, the rules are still being developed and additional proposals are expected to be released by year-end. Implementation will require ratification of a multilateral tax convention by a critical mass of countries, as well as changes to domestic law in some countries. At present, it seems doubtful Congress will implement Pillar One, throwing into question whether it ultimately will take effect.

> "
> Boards should be monitoring and anticipating potential tax changes at the individual country level in relevant jurisdictions.

Trade volatility

Supply chain resiliency is a growing focus of US trade policy, in the wake of pandemic supply chain challenges and global economic uncertainty. The increasing levels of government intervention in strategic supply chains, including semiconductors (as with the CHIPS and Science Act) or EVs (as with the IRA) have solidified the shift from more open globalized trade to greater promotion of domestic producers and fragmented markets for multinationals, which will have tax impacts.

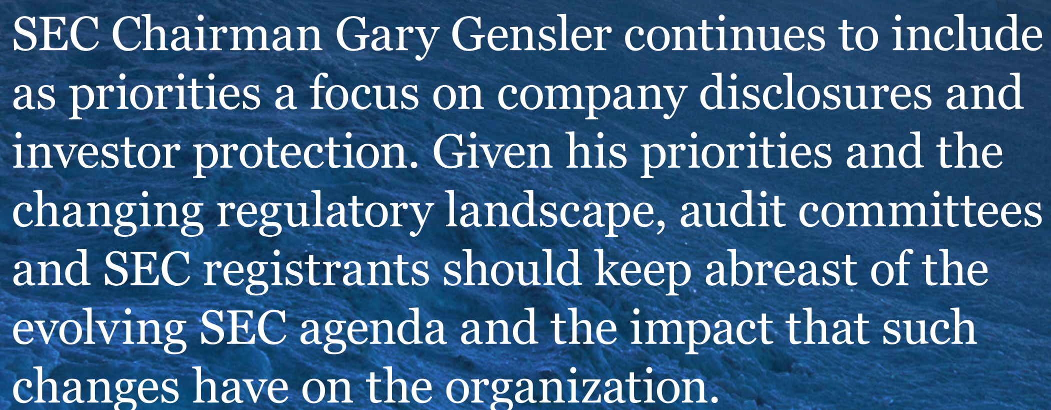
Additionally, tensions continue to escalate across a range of fronts with China, including continued Section 301 tariffs on Chinese imports, increased restrictions on exports of sensitive semiconductor chips, and rising foreign policy and security tensions.

Given the current uncertain geopolitical environment, companies and their boards should monitor political risks and watch for shifts in leadership and elections in key countries, foreign policy actions, tariff changes and regional trade agreements.

4

What audit committees should prioritize in 2023

Regulatory developments



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

SEC's regulatory agenda

Chairman Gensler has put forward an ambitious regulatory agenda, including potential changes to rules governing disclosures about climate-related and other ESG matters (e.g., board diversity, human capital), cybersecurity risk governance and other corporate governance matters (e.g., proxy rules, pay vs. performance). More information is available on its rulemaking agenda, which the SEC updates semiannually.

Perhaps the highest profile SEC rulemaking relates to climate disclosure. The SEC is currently considering the public's feedback on its proposal to enhance and standardize disclosures that public companies make about climate-related risks, their climate-related targets and goals, their greenhouse gas (GHG) emissions and how the board of directors and management oversee climate-related risks. The proposal would also require registrants to quantify the effects of certain climate-related events and transition activities in their audited financial statements. The SEC received thousands of comment letters on the proposal and now must decide whether and how to amend the proposal before voting on a final rule. A final rule is expected in 2023.

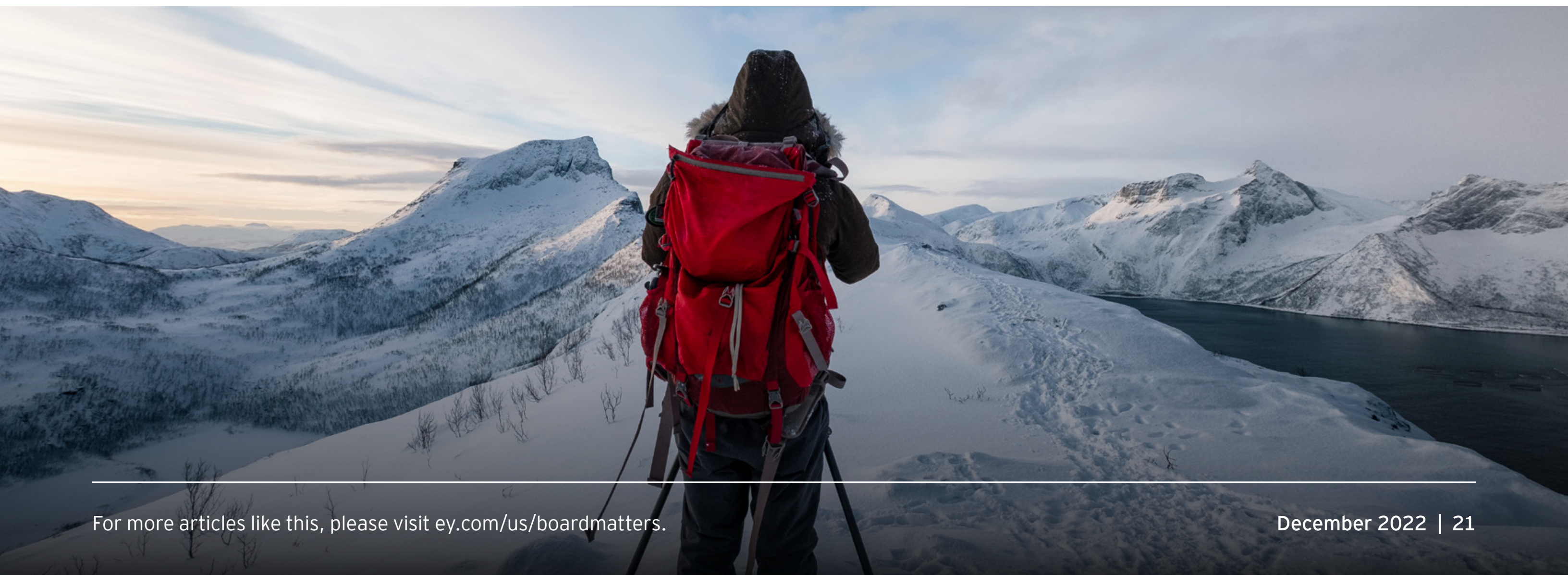
The SEC also is considering feedback on proposed new rules to enhance and standardize disclosures registrants make about their cybersecurity risk management, strategy and governance. The SEC proposal also would require registrants to disclose information about material cybersecurity incidents on Form 8-K within four business days of determining that the incident is material. The SEC plans to issue a final rule by April 2023.

Audit committees should consider how their companies should be preparing for potential regulatory changes, which could impact reporting requirements, disclosures, and policies and procedures.

Key actions for the audit committee may include:

- Evaluate the implications arising from SEC rulemakings related to ESG matters, including climate and cybersecurity risk and how the board oversees these risks.
- Evaluate whether the company has robust and adequate disclosure controls and procedures over the company's existing climate- and cyber-related disclosures to prepare for final rules by the SEC (including any potential need for third-party assurance).
- Continue to monitor how the company is addressing existing requirements for disclosures about human capital resources as well as how those disclosures may evolve. Additionally, inquire as to ways management can enhance data and information gathering practices to further enhance the overall quality of these disclosures.
- Evaluate how the company is effectively engaging with shareholders regarding shareholder proposals.
- Monitor the implementation of the EU Corporate Sustainability Reporting Directive (CSRD), which will require a number of non-EU companies with EU operations to provide climate- and other ESG-related disclosures. The CSRD is expected to be finalized in 2022 and implemented within 18 months.

> "The SEC proposal would also require registrants to quantify the effects of certain climate-related events and transition activities in their audited financial statements.



Newly adopted SEC rules

Pay vs. performance

The SEC adopted rules that require registrants to disclose the relationship between their executive compensation and financial performance (e.g., total shareholder return, net income, a company-selected measure) in a table for the five most recently completed fiscal years. The rules apply to all registrants except emerging growth companies, foreign private issuers and registered investment companies other than business development companies. The SEC has provided certain relief to smaller reporting companies.

Registrants must begin providing the disclosures in proxy and information statements that are required to include executive compensation information for fiscal years ending on or after 16 December 2022. Therefore, disclosures will be required in early 2023 for calendar-year companies. Companies and audit committees should evaluate implications and reporting considerations relating to the above — refer to the EY To the Point publication for additional details.

Incentive-based compensation clawbacks

The SEC adopted final rules to direct national securities exchanges and associations to establish listing standards requiring listed companies to claw back incentive-based compensation received by current and former executive officers during the three years preceding an accounting restatement. The rules require companies to disclose their clawback policies and any compensation subject to clawback in annual reports and in proxy and information statements. The rules apply to most listed companies, including smaller reporting companies, emerging growth companies and foreign private issuers.

While many companies have voluntarily adopted clawback policies since the proposal was issued in 2015, they will likely need to revise them in light of the new rules. Many voluntary policies only apply to cases of fraud or misconduct, and some apply to a narrower group of executives or have a shorter lookback period than required by the new SEC rules. Companies that have clawback policies should review the terms and consider what changes are necessary to comply with the rules. Audit committees may also want to understand the population of executive officers who could be subject to clawbacks and review the terms of their compensation agreements with these executives. Refer to the EY To the Point publication for additional details.

SEC amends proxy rules related to proxy voting businesses

The SEC adopted amendments that rescind two conditions added in 2020 that proxy voting advice businesses had to meet to qualify for exemption from the proxy rules' information and filing requirement. Those conditions required that (1) registrants that are the subject of proxy voting advice have such advice made available to them in a timely manner and (2) clients of proxy voting advice businesses are provided with a means of becoming aware of any written responses by registrants to proxy voting advice. The amendments and the rescission of the guidance are effective as of 19 September 2022.

> "While many companies have voluntarily adopted clawback policies since the proposal was issued in 2015, they will likely need to revise them in light of the new rules.

SEC enforcement and auditor independence

Chairman Gensler and his senior staff have pursued a vigorous enforcement agenda, with a focus on bringing cases that hold wrongdoers accountable as well as have a deterrent effect in the market. Among the tools used to accomplish these goals are high monetary penalties and requiring admissions of guilt. The SEC announced that its monetary penalties in FY22 were the highest in its history.

Senior SEC staff also continued to highlight the importance of auditor independence and the shared responsibility of the auditor, management and boards in protecting it. Accordingly, audit committees should monitor and assess the auditor's independence carefully and regularly.

PCAOB outlook

The Public Company Accounting Oversight Board (PCAOB) has identified three key areas to further its investor protection mission: (1) modernizing its standards, (2) enhancing its inspections and (3) strengthening enforcement. The PCAOB has identified an ambitious standard-setting agenda and is actively working to update more than 30 standards within 10 standard-setting projects. Audit committees, external auditors and SEC registrants should keep abreast of the new Board's strategic priorities and standard-setting agenda as it develops in the coming months and the impact that such changes can have on the execution of audits and overall audit quality.

In June 2022, the PCAOB released its *Spotlight: Staff Overview for Planned 2022 Inspections*, which provides discussion of the PCAOB's focus areas in the current inspection cycle. Additionally, in August 2022 the PCAOB published a new resource for audit committees titled *Spotlight: Audit Committee Resource*. This resource provides a reference point for audit committees by offering questions they may want to consider as part of their ongoing engagement and discussions with external auditors. Both documents may be useful as they highlight some of the anticipated financial reporting and audit risks. They may also provide audit committees insights into the external auditor's work plan for the upcoming audit cycle.

Other notable PCAOB developments

- **PCAOB proposes a new quality control standard**
  The Board views this proposal, issued in November, as a milestone for the PCAOB and audit quality, observing that the considerable revisions would lead registered public accounting firms to significantly improve their quality control (QC) systems. If adopted, the proposal would replace the current QC standards in their entirety and provide a framework for a firm's QC system based on proactive identification and management of risks to quality as well as ongoing monitoring and remediation of any deficiencies.
- **PCAOB signs agreement on inspections and investigations in mainland China and Hong Kong**
  The PCAOB signed a historic Statement of Protocol (SOP) with the China Securities Regulatory Commission (CSRC) and the Ministry of Finance of the People's Republic of China (PRC), an important first step in opening access for the PCAOB to inspect and investigate registered public accounting firms headquartered in mainland China and Hong Kong completely. The ability of the PCAOB to do so ultimately will determine whether Chinese and Hong Kong companies will be able to continue to trade in the United States, as determined by the Holding Foreign Companies Accountable Act.
- **PCAOB amends standards for group audits, adopts new standard on referred-to auditors**
  The PCAOB amended its auditing standards on supervision, including Auditing Standard (AS) 1201, *Supervision of the Audit Engagement*, to strengthen the requirements and responsibilities that apply to lead auditors who plan and perform audits that involve other auditors (i.e., component teams). The PCAOB also adopted a new auditing standard, AS 1206, *Dividing Responsibility for the Audit with Another Accounting Firm*, that will apply when the lead auditor divides responsibility for an audit with another accounting firm called a "referred-to auditor." The standards are effective for audits of financial statements for periods ending on or after 15 December 2024.

5

What audit committees should prioritize in 2023

Questions for audit committees to consider

Risk management

- Do scenario analyses consider an appropriate range of extreme and even improbable scenarios, including existential threats? Do they incorporate the potential compounding effects of various risks? Are the assumptions that underpin the organization's strategic plans still valid?
- Did the organization's stress testing account for ongoing inflation, Federal Reserve rate hikes, geopolitical tensions, labor shortages, technology changes, shifts in consumer preferences or climate change? Has the organization conducted financial risk modeling analyses to evaluate routine (low-impact, high-likelihood) scenarios vs. black swan (high-impact, low likelihood) events?
- What data science techniques and analytic tools is the organization using to evolve enterprise risk management to deliver deeper insights and create real-time alerts around emerging and disruptive trends to enable more effective decision-making and enhance resiliency?
- How can the organization build resiliency while remaining lean and agile enough to respond to unforeseen risks? Are contingency and response plans related to risks including cybersecurity and supply chain periodically simulated and reviewed with the board?
- How is the company seizing strategic opportunities to tap into larger talent pools? How is the organization nurturing its existing and future talent pools (e.g., re-skilling and upskilling, educational alliances) to position the company to meet current requirements, address enterprise risks and prepare for continued strategic pivots?
- How has the company's cybersecurity risk management program evolved to address the post-pandemic context in which attackers are targeting a larger surface area and using increasingly unpredictable tactics? How is cybersecurity proactively integrated into all major strategy or tactical decisions such as transactions, alliances, new products or services, and technology upgrades?

Financial reporting

- Has management assessed whether the company's current disclosures on climate related matters consider the SEC's 2010 guidance on the same topic?
- Have there been any material changes to internal controls over financial reporting or disclosure controls and procedures to address the changing operating environment? Have any cost-saving initiatives and related efforts impacted resources or processes that are key in internal controls over financial reporting? If so, has management identified mitigating controls to address any potential gaps?

External auditors:[1]

- How have economic factors (e.g., supply chain disruption, inflation) influenced the auditor's risk assessment for the current year's audit?
- If other auditors were used in Russia, Ukraine or Belarus, were there difficulties in communicating with or assessing the other auditor's procedures? If so, did the lead auditor determine that it was required to develop an alternative plan for supervising or using the work and reports of other auditors?
- In the auditor's view, how has staff turnover at the company impacted (1) the quality of the company's accounting and financial reporting processes and internal controls and (2) the company's preparation for the audit?

[1] Excerpted from *PCAOB Spotlight: Audit committee Resource, August 2022*.

Tax and other policy-related developments

- Has the organization analyzed the impacts on the company of federal tax legislation enacted in 2022? Has the company performed modeling and scenario planning reflecting potential tax policy changes and trade developments?
- As it relates to the IRA, has management fully vetted the landscape of federal incentive opportunities and how they apply to the company? What are the applicability, timing and process for disbursements of tax incentives offered under the IRA?
- Does management have the resources within the tax function to monitor international, US federal and state legislative and regulatory developments and their impacts on the company, and what oversight does the committee have of the processes?
- Does the organization have a plan for the BEPS 2.0 Pillar Two impact on the provision, compliance and reporting functions?
- Are any transactions anticipated that could result in the company being subject to these new taxes?
- How is the organization preparing for tax legislative changes in the states in which it does business?

Regulatory developments

- Does the company have sufficient controls and procedures over nonfinancial data? Is internal audit providing any type of audit coverage on ESG-related data or is the company obtaining any external assurance?
- If ESG-related matters are being discussed in more than one place (e.g., SEC filings, earnings releases, analyst communications, annual report and shareholder letter, sustainability report), is there consistency in the disclosures? Has the company evaluated controls related to such disclosures?
- How is the organization proactively assessing opportunities to enhance stakeholder communications, including corporate reporting, to address changes in operations and strategies as well as changing stakeholder expectations?
- 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?
- In light of the changing environment, what additional voluntary proxy disclosures might be useful to shareholders related to the audit committee's time spent on certain activities, such as cybersecurity, data privacy, business continuity, corporate culture and financial statement reporting developments?

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