

EY Center for Board Matters

How audit committees can prepare for 2022 Q3 reporting

Presented by the EY Audit Committee Forum

In this edition of our quarterly review of issues affecting audit committees, we summarize key developments for audit committees to consider. The audit committee role grows more demanding and complex amid fast-paced change, and this report will assist audit committees as they proactively address recent and upcoming developments impacting Q3 reporting and beyond.

In brief

- Audit committees need to maintain vigilance over cybersecurity and learn how leading companies are addressing the future of cyber risk.
- It is important to understand how macroeconomic developments, including inflation, rising interest rates and the war in Ukraine, might impact financial reporting.
- The SEC continues to engage in rulemaking, and audit committees should consider how to best prepare for potential regulatory changes.

Risk management

Given the ongoing changes in the business environment, it remains essential for audit committees to stay on top of critical drivers of risk and changing macroeconomic conditions (e.g., impacts stemming from inflation, rising interest rates, recession risk) to better assess near- and long-term risk implications to companies. Key actions for audit committees may include:

Enhancing risk resiliency

- ▶ Continue to review updates to scenario plans, stress testing and contingency planning. Assess whether assumptions underpinning the strategic plan have been stress-tested to incorporate disruptive outside forces (e.g., market events, geopolitical tensions, cybersecurity and infrastructure security threats, labor shortages, technology changes, changing demand/consumer preferences, climate change). Further, determine if the organization has executed financial risk modeling analyses to evaluate routine (low-impact, high-likelihood) scenarios vs. "black swan" (high-impact, low-likelihood) events.
- ▶ Understand how management is assessing and managing risk aggregation and interdependencies across the company's entire value chain, including resiliency, suitability, cybersecurity, and social and environmental impacts of its supply chains and other third parties on which the organization relies. Additionally, as companies reconfigure supply chains to reduce costs and minimize uncertainty, it is important to assess how supply security can be further enhanced. For example, are key suppliers executing equally rigorous cyber risk management programs, and how does the organization affirm such?
- ▶ Understand whether management is building systematic resiliency and using artificial intelligence (AI) for foresight into emerging and disruptive trends.

Maintaining vigilance over cybersecurity

- ▶ Assess how the organization is maintaining a consistent level of diligence and cyber hygiene to defend against the continued wave of ransomware and cybersecurity attacks. Evaluate plans to monitor, evaluate, communicate and disclose cyber attacks, particularly in light of the SEC's proposed cybersecurity disclosure rules released on March 9.
- ▶ Considering the war in Ukraine and the recently issued "Shields Up" guidance issued by the Cybersecurity & Infrastructure Security Agency (CISA), determine what incremental actions have been or should be implemented as a result of such heightened risks. Inquire whether management is lowering its thresholds for reporting anomalies internally (including to the board) and to external stakeholders (e.g., regulators and the broader cyber community) given that corporations will likely see the impacts and movements before governmental agencies.
- ▶ Determine if management has elevated the sophistication of its cyber incident response plans, and accordingly practiced those updates through more rigorous simulation drills, including surprise exercises, which most closely resemble real-world attacks.
- ▶ Assess the efficacy of the company's cyber insurance coverages. Inquire with management whether additional terms and conditions have been recently added and evaluate the related implications.

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Overseeing talent strategies and culture

- ▶ Consider whether information security measures and other controls have been reviewed and adapted to be responsive to ongoing digital acceleration efforts, technology changes and the shifting business environment. Further, inquire of management as to what degree of assessments and testing have been performed to infuse cybersecurity proactively (e.g., trust by design) in all major strategic or tactical decisions such as transactions, alliances, new products or services, and technology upgrades.
- ▶ Determine how new technologies for audit and finance functions align with existing employee talent, skills and capabilities and evaluate whether the company has the talent and skills necessary to adapt to its changing needs.
- ▶ Evaluate how the organization is assessing risk and positioning for the risk upside of Web 3.0 and the metaverse, including its effects on employee behaviors.
- ▶ Assess how talent acquisition and retention strategies are evolving to keep pace with the hypercompetitive labor market and the need to contend with business transformations.
- ▶ Continue to evaluate whether future plans will change risks or necessitate changes in the design of internal controls. Consider how process changes, including people changes (e.g., terminations, hiring, reorganizations, hybrid work environment) are impacting the performance and effectiveness of key controls and the potential for control deficiencies along with heightened fraud risks.

Monitoring regulatory changes and other external developments

- ▶ Plan for a changing regulatory environment – such as emerging oversight of how companies can store and use data for commercial ends.
- ▶ Assess impacts and modeling efforts relating to the recently passed US Inflation Reduction Act (IRA). In particular, evaluate how the company is embedding federal, state and local incentives in the company's capital investment strategy to help drive consistent return on investment.
- ▶ Assess whether the company has begun to model the effects of the Organisation for Economic Co-operation and Development (OECD) Pillar 2 global minimum taxation policy to be finalized in 2022 and the potential changes to federal and foreign tax laws. Evaluate what effects these will have on the overall business operations, including plans for systems and controls to manage the changes.
- ▶ Consider how evolving tax policy and new tax laws (e.g., IRA) may impact any significant transformations (e.g., workforce changes, digital and supply chain transformation, mergers and acquisitions (M&A)).
- ▶ Consider what additional metrics the board and audit committee should monitor in light of the changing environment.

¹ <https://www.cisa.gov/shields-up>

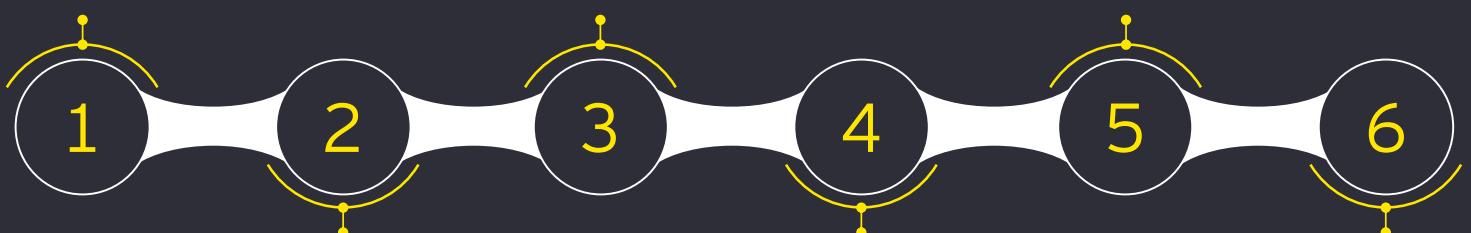
What we're hearing from audit committee chairs on the future of cyber risk

While cybersecurity has been a well-established topic on board and audit committee agendas for several years, constant vigilance is required to keep pace with an ever-changing and intensifying risk landscape. Companies are experiencing ongoing nation-state and ransomware attacks, increased exposure fueled by digital transformation efforts, and risks stemming from emerging technologies such as AI and machine learning.

Tapestry Networks recently brought together one of the foremost authorities on cybersecurity and cyber executives from leading companies to meet with the audit committee chairs of more than 100 large US public companies to exchange views on the future of cyber and other emerging risks. Tapestry Networks summarized the key points arising from this discussion in its recently released report: [The future of cyber risk](#).

Notable themes from these discussions include:

- ▶ Cyber threats are creating a growing and complex risk landscape: Diverging priorities between the United States and nations such as China and Russia are fueling cyber threats that directly impact companies, underscoring the need to stay on high alert. In addition to theft of intellectual property, there is a growing risk of data destruction, which may create near-term risk in supply chains.
- ▶ Audit committees can drill down to understand and prepare for future vulnerabilities: One of the cyber experts recommended that audit committees ask management about near misses, not just the big breaches. A good practice that was shared with audit committee chairs included bringing in business unit leaders on a rotating basis to explain their cybersecurity practice in order to receive different perspectives on the cyber topic.
- ▶ Organizations need to be crypto agile: Data security is a high priority for companies amid the current threat environment, where data is continuously targeted by myriad bad actors. AI, machine learning and quantum capabilities used for malicious purposes bring even more urgency to this issue. As existing encryption methods become ineffective, companies should stay abreast of new technologies and prioritize the protection of sensitive data and assets. Audit committee chairs were advised to make crypto agility a priority and to make sure that their companies are prepared to rapidly respond to any changes in cryptographic standards.



- ▶ Technology advancements are creating new types of risks: New technologies such as AI and machine learning can create opportunities for companies but also bring new cybersecurity and ethical risks. Boards should ask questions about what checks and balances are in place as new technologies are developed and deployed at their companies. Criminals can quietly modify the data that trains a machine learning system, leading to misclassifications and operational damage that may take many months to detect.
- ▶ Talent management is a top cyber concern: Given the competitiveness of cyber talent, boards should ask their chief information security officers about how they develop and retain talent for their cyber and technology programs. A good practice includes companies working closely with human resources teams and universities to develop talent early.
- ▶ Disinformation is an emerging risk for companies: Disinformation is easy to create and spreads quickly, making it particularly dangerous. Unlike traditional cyber threats, targeted disinformation events have a low barrier to entry, requiring less sophistication and very little technical acumen. Most audit committee chairs indicated that disinformation is a new risk area that is not on their boards' current agendas, but should be. Actionable recommendations include training employees to recognize disinformation, creating an incident response plan that outlines key processes and decision-makers in the event of a disinformation incident, and holding practice drills.

Source: [Tapestry Networks' Audit Committee Leadership Summit: The future of cyber risk, August 2022](#)

Accounting and disclosures

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 expect 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. Known trends or uncertainties may include inflation, rising interest rates, the war in Ukraine, and supply chain disruptions that affect the relationship of costs to revenue. Revisit other 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.
- ▶ Review and inquire with management whether the company has appropriately considered the questions raised by the SEC staff in the sample comment letter published in May 2022. While the sample comment letter focused on the direct and indirect effects of the war in Ukraine, many of the considerations may apply to other macroeconomic factors as well. In addition, as a result of the war in Ukraine, many companies have experienced heightened cybersecurity risks and should consider whether these risks warrant disclosure.
- ▶ Evaluate implications to the company of the SEC staff's recently issued comment letters asking about the impact or expected impact of supply chain disruptions. Companies should consider quantifying these effects if they are determinable. The level and nature of the disclosure will depend on a company's facts and circumstances, including the implications for its operations, liquidity and financial condition.
- ▶ Determine whether there are indicators of impairment for long-lived assets, goodwill and indefinite-lived assets, equity method investments or certain financial assets measured at amortized cost as a result of company-specific specific actions or circumstances, or due to one or a combination of macroeconomic factors. Additionally, if there is a significant decrease in volume or level of activity, determine whether valuation techniques used to measure fair value are still appropriate.

The passage of the IRA will result in many companies being subject to the new corporate alternative minimum tax (CAMT) effective for years beginning after 31 December 2022. Companies projecting to be CAMT payers indefinitely after the effective date may need to consider, in this quarter, the impact on the realizability of certain deferred tax asset carryovers if they also anticipate needing a valuation allowance on any CAMT credit carryovers they will now project in their forecasts. If the effects of the tax law changes are, or will be, material to a company, the company should consider the disclosure implications in preparing its management's discussion and analysis (MD&A) under Item 303 of Regulation S-K, including its discussion of results of operations and liquidity and capital resources. For example, reassessment of the realizability of deferred tax assets may have a material effect on a registrant's income tax provision. In addition, if material, companies may need to start providing disclosures about the effect the tax law changes could have on their effective tax rates when the IRA provisions become effective.

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.

SEC and other reporting considerations

The SEC has continued to engage in rulemaking that impacts public companies in Q3, including a final rule on proxy advice and proposed rule amendments relating to shareholder proposals.

Regarding proxy advice, the SEC adopted amendments that rescind two conditions added in 2020 that proxy voting advice businesses have 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. These amendments are effective as of 19 September 2022.

The SEC also proposed amendments to its shareholder proposal rule, Exchange Act Rule 14a-8, which generally requires companies to include shareholder proposals in their proxy statements absent a basis for exclusion. The proposed amendments would narrow certain substantive bases that permit the exclusion of shareholder proposals in proxy statements. Comments on this proposal are due by 12 September.

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. If the rules are adopted as proposed by the end of 2022, the compliance date (which depends on a

registrant's filer status), would be phased in beginning with fiscal year 2023.

In June, the SEC also issued an [updated rulemaking agenda](#) for the coming months, which includes plans to propose rules to require disclosures on human capital later this year and board diversity in 2023.

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

Key actions for the audit committee may include:

- ▶ Evaluate how the company is effectively engaging with shareholders regarding shareholder proposals.
- ▶ Evaluate the implications arising from SEC rulemaking related to environmental, social and governance (ESG) matters, including climate and cybersecurity risk and how the board oversees these risks. Additionally, evaluate with management how commenting on SEC rule proposals may impact investors.
- ▶ Evaluate whether the company has robust and adequate disclosure controls and procedures over the company's existing climate-related disclosures to prepare for a final rule 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.

Additional resources

- ▶ [SOX at 20: the enduring legacy of the Sarbanes-Oxley Act](#)
- ▶ [SEC in Focus - July 2022 | EY - US](#)
- ▶ [To the Point - SEC proposes enhancing and standardizing climate-related disclosures | EY - US](#)
- ▶ [To the Point - SEC proposes requiring more cybersecurity disclosures | EY - US](#)
- ▶ Refer to the [EY publication Technical Line - Revisiting the SEC's guidance on climate change disclosures in today's environment](#) for additional discussions aimed at helping registrants apply the commission's 2020 climate change guidance today and respond to any inquiries from the SEC staff about their disclosures.
- ▶ See also the Financial Accounting Standards Board (FASB) staff's recently issued document [Intersection of Environmental, Social, and Governance Matters with Financial Accounting Standards](#), which highlights the connection between ESG matters and their direct and indirect effect on the financial statements.
- ▶ Refer to the EY publication [How do you value your social and human capital?](#) for our analysis of the first human capital disclosures made by public companies to satisfy the SEC requirement adopted last year.

Notable PCAOB updates

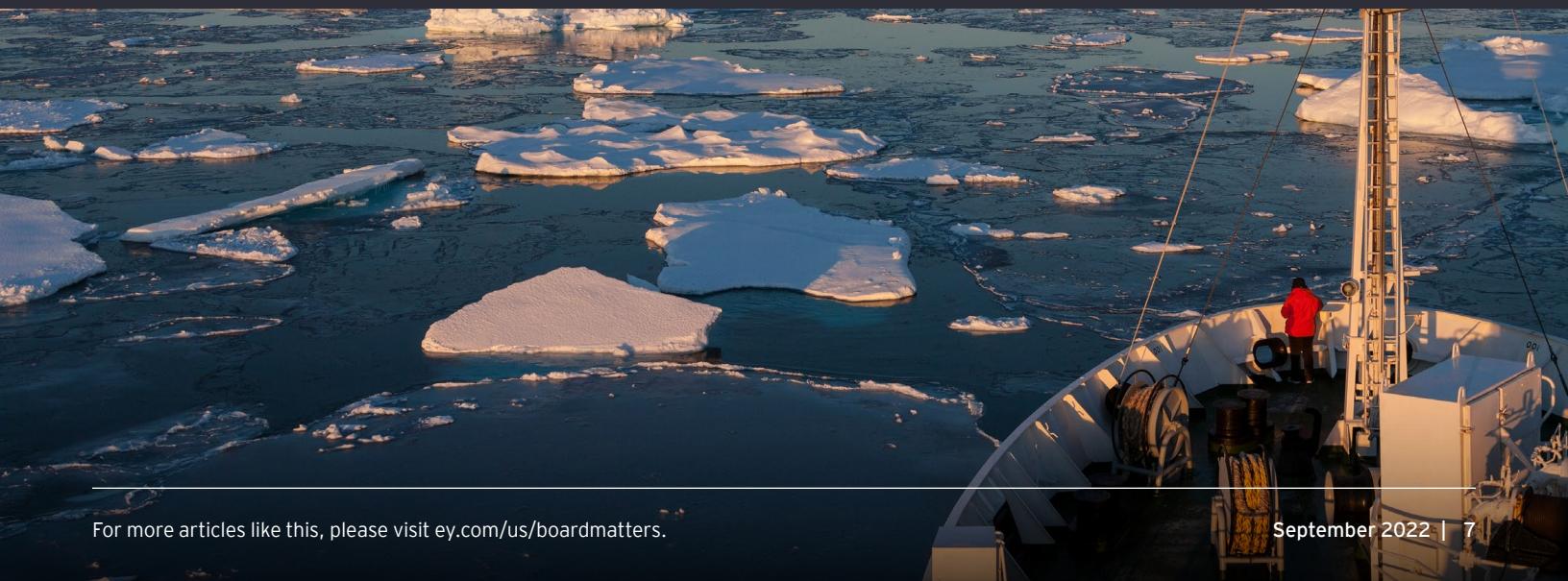
In June 2022, the Public Company Accounting Oversight Board released its [Spotlight: Staff Overview for Planned 2022 Inspections](#), which provides discussion of the PCAOB's focus areas in the current inspection cycle. Some of the key excerpts and selected areas of inspections focus are:

- ▶ Fraud and other risks.
- ▶ Key auditing and accounting risks, including a) unreasonable assumptions affecting the timing and amount of revenue recognition due to the negative effects of the COVID-19 pandemic and supply chain disruptions; b) unreasonable assumptions used in projections to account for business combinations or in testing goodwill or other intangibles for impairment; c) earnings manipulation; d) complexities regarding existence and valuation of inventory; e) financial, economic and business uncertainty that impacts the required assessment to evaluate threats and uncertainties concerning a public company's ability to continue as a going concern.
- ▶ IPOs and M&A activity, with focus on the auditor's work on the following: (1) valuation of financial instruments using complex valuation models; (2) the determination of whether a business combination should be accounted for as a reverse merger; (3) internal control over financial reporting; (4) financial statement presentation and disclosures; and (5) restatements related to warrants or other issues.

- ▶ Audit firms' execution challenges.
- ▶ Audit areas with continued deficiencies, including revenue recognition and related risk assessment; allowance for loan losses and other accounting estimates; and internal control over financial reporting (particularly controls with a review component).
- ▶ Other noted focus areas include: broker dealer-specific considerations, independence, use of service providers in the confirmation process, critical audit matters (CAMS), firms' quality control systems, and technology (in particular – auditing digital assets, responding to cyber threats, use of data and technology in the audit).

The Spotlight document may be useful to audit committees as it highlights some of the anticipated financial reporting and audit risks and issues that may be challenging in the current environment. It may also provide audit committees insights into the external auditor's work plan for the upcoming audit 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 the external auditors. The topics and questions are reflective of the current economic environment and include questions that are reflective of the PCAOB's inspection focus areas.



Inquiries with management, compliance personnel and auditors

In discussions with management, compliance personnel and auditors, audit committees should consider the following in addition to standard inquiries:

Risk management-related inquiries

- ▶ 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?
- ▶ What processes does management have in place to accelerate idea generation, trialing and assessment while also encouraging appropriate risk taking? What more can be done to accelerate digital transformation efforts and foster a culture of innovation?
- ▶ 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?
- ▶ In the event of a ransomware attack, what protocols and criteria will be considered to determine if/when/how ransom will be paid? For example, what are the insurance protocols? Should the organization have a ransom negotiator on retainer? Do system backups exist and what is the projected speed of deployment? If ransom is paid to an ill-defined attacker with an unknown location, what regulatory and legal implications might inadvertently be triggered?
- ▶ As it relates to the Inflation Reduction Act of 2022, has management fully vetted the landscape of federal incentive opportunities and how they apply to the company? What is the applicability, timing and process for disbursements of tax incentives offered under the new law(s)?
- ▶ What has management done to analyze the expected impact of the CAMT on the entity and, if projected to be a CAMT payer, has the company modeled the impact on existing deferred tax carryovers for purpose of the quarter's valuation allowance assessment? Likewise, has the company considered the impact of the new 1% excise tax on stock repurchases made after 31 December 2022 in its budgets being established in third and fourth quarter? Finally, related to the IRA and the CHIPS & Science Act of 2022 (CHIPS) also enacted this quarter, has the company assessed the many tax credit incentives available for investment in production and green energy, including those for expenditures incurred this year?
- ▶ What, if anything, is management doing to plan for potential tax policy changes in response to the OECD Pillar 2 global minimum tax model to which 144 countries (including the US) have agreed thus far? In particular, is management monitoring proposed tax legislation to adopt the Pillar 2 rules in the US and elsewhere? What is being done to address the expected increase in worldwide corporate effective tax rates and the systems and control enhancements that will be required to track new tax regimes as they are legislated? Is management planning any internal restructuring transactions to mitigate the increased worldwide taxes that may occur once any country represented within the consolidated reporting entity legislates the Pillar 2 principles, triggering the accounting for the entire group?
- ▶ Does management have the resources within the tax function to keep pace with, and evaluate on a quarterly basis the impacts to the company of, the new CAMT (if applicable), OECD global minimum taxation, and new environmental/carbon taxes being legislated globally?
- ▶ What more can and should be done through technology, training and manager support to optimize connectivity, engagement, security and productivity?
- ▶ Has the organization revisited and updated its training programs to consider the current and changing business landscape, new controls, new systems and revised regulations?
- ▶ How is the organization monitoring compliance with federal, state and local regulations and health guidelines, employee/customer health and safety, privacy and confidentiality?
- ▶ Have there been any meaningful changes to the company's key policies, any material exceptions granted or any unusual allowances to any compliance provisions?

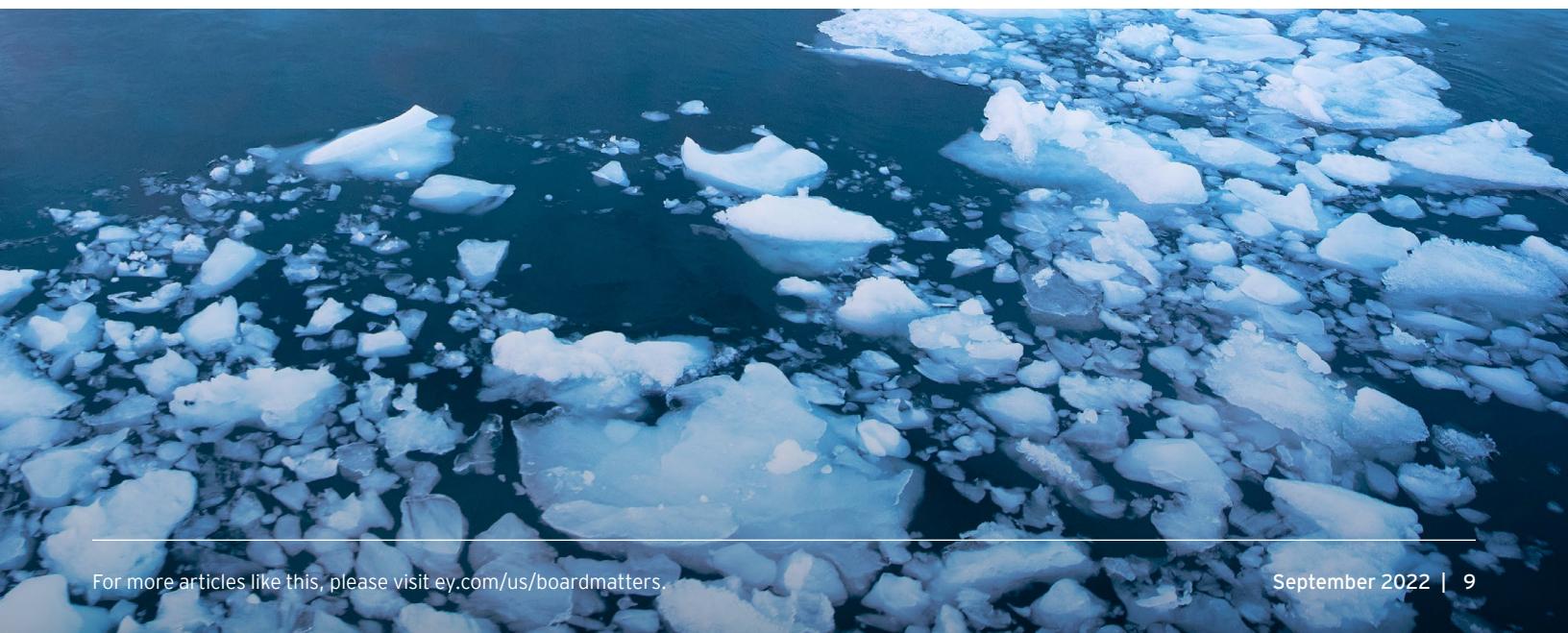
Accounting, disclosures and other financial reporting related inquiries

- ▶ What are the nonrecurring events and circumstances that have transpired and what are the related financial reporting and disclosure implications?
- ▶ In light of the current environment (including the macro market conditions), has the company evaluated how current market developments may change the value of assets and whether there are impairment indicators for assets such as property, plant and equipment, definite and indefinite-lived intangibles, inventory, receivables, debt and equity investments? Have the valuation technique(s), inputs and assumptions been appropriately revisited and updated?

- ▶ Has the company appropriately determined any necessary disclosures this quarter to address the impact of the passage of the IRA and CHIPS Act?
- ▶ Are the company's nonfinancial disclosures fit for purpose given current investor stewardship priorities, investing trends and related investor data needs?
- ▶ 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, corporate social responsibility report), is there consistency in the disclosures?
- ▶ Has the company evaluated its disclosures in light of Institutional Shareholder Services' addition of 11 cyber-specific inquiries related to cyber risk?
- ▶ How is the organization proactively assessing the opportunity to enhance stakeholder communications, including corporate reporting to address changes in operations and strategies as well as changing stakeholder expectations?
- ▶ Have there been any material changes to internal controls over financial reporting or disclosure controls and procedures to address the changing operating environment? Have any cost-saving initiatives and related efforts impacted resources and/or processes that are key in internal controls over financial reporting? If so, has management identified mitigating controls to address any potential gaps?

Inquiries to auditors

- ▶ Can financial reporting, compliance and auditing procedures (internal and external) continue to be adequately performed through a combination of physical and remote working procedures? What options are there to perform alternative procedures to facilitate timely collection, processing and reporting of information for internal use and to prepare regulatory filings?
- ▶ External auditors: What changes are expected with materiality, scope and additional procedures in light of changes in the current business environment? What are the potential impacts on the audit arising from the complete or partial transition back to the office? Has the engagement team identified any incremental risks and/or adjusted its audit response in light of the war in Ukraine? If so, what are the impacts to the engagement's audit strategy and overall approach to the interim reviews? How has the engagement team considered changes to the incentive, opportunity and rationalization of the fraud triangle?
- ▶ If the company will be subject to the CAMT, what processes and controls will it need to adequately capture the data needed to calculate the taxes under the new regime?
- ▶ Internal auditors: How should audit plans be adjusted to address changes in risk appetite and tolerances as identified from the company's ERM program? Are there any audit plans that are not being executed, or has the scope of the work been changed?



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