

Update

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AUDIT COMMITTEE AND AUDITOR OVERSIGHT UPDATE

This Update summarizes recent developments relating to public company audit committees and their oversight of financial reporting and of the company's relationship with its auditor.

SEC Issues Staff Guidance on Financial Reporting Implications of Tax Reform

On December 22, President Trump signed the Tax Cuts and Jobs Act (Tax Act). The Tax Act makes far-reaching changes in the taxation of U.S. companies and will have significant financial reporting and disclosure impacts of which audit committees will need to be aware. On the same day as the bill was signed, the SEC issued [Staff Accounting Bulletin No. 118](#) (SAB 118) and [Compliance and Disclosure Interpretation 110.02](#) to provide guidance on some of the near-term disclosure challenges that public companies will face as the result of tax reform. The SEC Commissioners also released a brief [statement](#) on the new staff guidance.

Accounting Standards Codification Topic 740, [Income Taxes](#) (ASC Topic 740), requires that the effects of a change in the tax laws be reflected in the financial statements for the reporting period in which the change became law. SAB 118 states that the SEC staff "understands from outreach that registrants will potentially encounter a situation in which the accounting for certain income tax effects of the Act will be incomplete by the time financial statements are issued for the reporting period that includes the enactment date of December 22, 2017." (These effects might include, for example, changes in the valuation of deferred tax assets (DTAs) or deferred tax liabilities reported on the company's financial statements or the financial statement impact of the new tax regime for foreign earnings.) SAB 118 permits companies to address this problem by dividing the tax effects of the new law into three categories:

- [Accounting is incomplete, but effects can be reasonably estimated.](#) If the company's accounting for particular income tax effects of the Tax Act is incomplete, but it can determine a reasonable estimate of the effects, the company may include the reasonable estimate in its financial statements. The reasonable estimate would be reported as a "provisional amount" during a "measurement period." This alternative addresses "circumstances in which an entity does not have the necessary information available, prepared, or analyzed (including computations) in reasonable detail to complete the accounting under ASC Topic 740."

For companies taking this approach, the measurement period begins in the reporting period that includes December 22 and ends when the company has the information needed to complete the accounting under ASC Topic 740. The measurement period may not be longer than one year, and “the staff expects that entities will be acting in good faith to complete the accounting under ASC Topic 740.”

- Accounting is incomplete and effects cannot be reasonably estimated. With respect to some effects of the Tax Act, the company may not even have the necessary information available to make a reasonable estimate. In that case, the company “should continue to apply ASC Topic 740 (e.g., when recognizing and measuring current and deferred taxes) based on the provisions of the tax laws that were in effect immediately prior to the Act being enacted.” Stated differently, a company should not adjust tax items previously reported on its financial statements until it has sufficient information to make a reasonable estimate of the effects of the Tax Act.
- Accounting is complete. In accordance with ASC Topic 740, a company must reflect the income tax effects of the Act as to which the accounting is complete in its financial statements for the reporting period in which the new law was enacted. Therefore, if the company can determine the effects of the Tax Act, those effects must be reported in the financial period that includes December 22.

SAB 118 also discusses the financial statement disclosure ramifications of a company’s inability to complete its ASC Topic 740 accounting. Companies should provide in their financial statements material information concerning the impact of the new tax law, including:

1. Qualitative disclosures of the income tax effects of the Act for which the accounting is incomplete.
2. Disclosures of items reported as provisional amounts.
3. Disclosures of existing current or deferred tax amounts for which the income tax effects of the Act have not been completed.
4. The reason why the initial accounting is incomplete.
5. The additional information that is needed to be obtained, prepared, or analyzed in order to complete the accounting requirements under ASC Topic 740.
6. The nature and amount of any measurement period adjustments recognized during the reporting period.
7. The effect of measurement period adjustments on the effective tax rate.
8. When the accounting for the income tax effects of the Act has been completed.

The new Compliance & Disclosure Interpretation (CD&I) addresses disclosure arising from asset impairments that result from the Tax Act. The

Tax Act's lower corporate tax rates may have the effect of reducing the value of DTAs reported on the company's financial statements. The CD&I provides that the re-measurement of a DTA as a result of the Tax Act is not an impairment under GAAP. Therefore, such a revaluation does not require trigger an obligation to file Form 8-K. (Item 2.06 of Form 8-K requires certain disclosures if a company determines that GAAP calls for a material impairment charge.)

The CD&I also notes, however, that the Tax Act could effect whether it is more likely than not that a DTA will be realized. Such a determination could result in an impairment charge. The CD&I states that companies using the measurement period approach described in SAB 118 that conclude that an impairment has occurred due to the Tax Act "may rely on the instruction to Item 2.06 and disclose the impairment, or a provisional amount with respect to that possible impairment, in its next periodic report." The instruction to which this statement refers provides that no Form 8-K filing is necessary when the impairment determination is made in connection with the "preparation, review, or audit of financial statements" that will be included in the company's next periodic filing. The periodic filing must be made on time and must disclose the impairment.

Comment: SAB 118 and the related CD&I address only the immediate problem of the difficulties associated with determining the financial reporting effects of the Tax Act and reflecting them in the reporting period that includes the date of enactment. In the longer run, the new law is likely to require managements and audit committees to grapple with a variety of disclosure and financial reporting issues.

Management's Discussion & Analysis (MD&A) disclosure is one example. Current year material changes to the company's financial reporting, such as those resulting from the Tax Act, would normally be explained in MD&A. Moreover, MD&A also requires discussion of known trends or uncertainties that are reasonably likely to have a material effect in the future on the reporting company's liquidity, capital resources, or results of operations. For many companies, the Tax Act may have financial statement impacts that fall within this requirement. More broadly, in some cases, the company's business plan or competitive strategy may be affected by the Tax Act, with attendant impacts on its MD&A and other disclosures.

Two Accounting Firms Have Some 2018 Suggestions for Audit Committee Agendas

Two major accounting firms – PwC and KPMG – have published their suggestions regarding the issues that audit committees should have on their current radar. These lists overlap in some respects, and both provide useful perspective on topics that audit committees may want to add to their agendas.

PwC

The PwC Governance Insights Center has issued [Approaching the 2017 year-end financial reporting season: Six areas the audit committee should be thinking about](#). This publication highlights "financial reporting issues, SEC trends and other developments" that audit committees should focus

on during this year's financial reporting season. PwC identifies six key issues:

1. The new revenue recognition standard effective date is almost here. What can we do to be ready? As described in several prior Updates (see, e.g., [Another Warning Bell Rings on Revenue Recognition, May-June 2017 Update](#)), the FASB adopted a new standard on revenue recognition, effective for public companies beginning with fiscal years that commence after December 15, 2017. Implementation has been a challenge for many companies. PwC recommends that audit committees consider certain post-implementation issues, including the results of tests of controls over implementation of the new standard and disclosures regarding the impact of the standard.
2. Are we on course to adopt the new lease accounting standard? The FASB has also adopted a new standard on leasing (see [FASB Adopts New Lease Accounting Standard, February-March 2016 Update](#)), effective for public companies beginning with annual reporting periods that commence after December 15, 2018. The standard will require that most leases be reflected as both an asset and a liability on the balance sheet. PwC notes that implementation of this standard will be "daunting" for many companies because of the need to review "hundreds or even thousands" of leases and other contracts that may have embedded lease arrangements. PwC lists nine implementation process and disclosure issues that audit committees should consider regarding the new leasing standard.
3. Are we on course to adopt the new hedge accounting standard? FASB has also amended the standards applicable to hedge accounting. These changes will be effective for fiscal years beginning after December 15, 2018, but can be applied early. PwC states that, "[s]ince the standard may influence the types of risk management strategies a company may pursue and it can be adopted any time after the issuance date, audit committees should start thinking about it now. There may be elective elements that are helpful for the company, and companies should prepare for the cost and the effort required to implement the required elements."
4. How will the newly approved auditor reporting model impact our audit? Prior Updates (see, e.g., [SEC Approves New Auditor's Reporting Model and Shifts the Discussion to Implementation \(November-December 2017 Update\)](#)) have described the PCAOB's new auditor's reporting model in detail. The most far-reaching change – the requirement that auditors disclose and discuss critical audit matters (CAMs) in their reports – will take effect for audits of the largest public companies for fiscal years ending on or after June 30, 2019. Among other things, PwC recommends that audit committees discuss the company's potential CAMs with their auditor and consider whether the company should change the nature and extent of its disclosure related to these matters.
5. Should we enhance the disclosure in our proxy statement about our audit committee? As discussed in several prior Updates (see, e.g., [Transparency Rolls On: Audit Committees are Voluntarily](#)

[Disclosing More About Their Work \(November-December 2017 Update\)](#), audit committee transparency – that is, voluntary audit committee disclosure concerning the committee's responsibilities and oversight activities – has been a major area of investor and regulatory interest during the last several years. Many audit committees have responded with enhanced disclosure concerning their work. PwC recommends that audit committees consider whether to expand their disclosures to better explain their work to investors and other stakeholders. Consideration of this issue should include a review of the Center for Audit Quality's Audit Committee Transparency Barometer (described in [Transparency Rolls On](#), referenced above) and of the disclosures peer company audit committees are making.

6. [Are we keeping pace with the evolving domestic and international tax landscape?](#) PwC cites the recent enactment of the Tax Cuts and Jobs Act (see [prior item in this Update](#)), along with international efforts aimed at preventing companies from shifting revenue to low-tax jurisdictions, all of which raise a variety of new tax and financial reporting and disclosure issues for companies. It recommends that, in response, audit committees consider a series of questions, including how the company's international tax structure could it be impacted and the adequacy of the company's disclosures related to taxation matters.

KPMG

KPMG offers a somewhat different take on what audit committees should be thinking about. The [January 2018 edition of the KPMG Board Leadership Center's Directors Quarterly](#) lists seven "top items that audit committees should keep in mind as they consider and carry out their 2018 agendas."

1. [Stay focused on job No. 1 – financial reporting integrity.](#) KPMG recommends that audit committees should reassess whether the committee has the time and expertise to oversee risks other than financial reporting or whether such issues as cybersecurity risk, supply chain risk, and legal and operational risk should be assigned to other committees.
2. [Financial reporting quality starts with the CFO and the financial organization; maintain a sharp focus on leadership and bench strength.](#) In KPMG's view, it is "essential that the audit committee devote adequate time to the finance organization, including the talent pipeline, training and resources, as well as succession plans for the CFO and other key executives in the finance organization."
3. [Monitor management's progress on implementing FASB's revenue standard and other accounting change on the horizon, and stay apprised of tax legislative and regulatory developments.](#) KPMG discusses two broad areas of audit committee focus: (1) how management views the impact of transition to the new standard and what the external auditor has done to evaluate transition impact, including the company's proposed disclosure regarding transition; and (2) the company's readiness to report under the new standard in 2018, including the impact on internal

control over financial reporting, disclosure, and disclosure controls and procedures.

4. Focus internal audit on the company's key risks, beyond financial reporting and compliance. KPMG urges that audit committees "work with the chief audit executive to help identify the risks that pose the greatest threat to the company's reputation, strategy, and operations and to help ensure that internal audit is focused on these key risks and related controls."
5. Reinforce audit quality and transparency. Audit committees should focus on the new PCAOB auditor's reporting model requirements, including the disclosure of CAMs, and should have "early dialogue" with their auditors concerning implementation. KPMG also states that audit committees should consider expanding the committee's report to provide more insight into how the committee discharges its responsibilities.
6. Monitor the impact of the business and regulatory environment, as well as tone at the top and corporate culture, on the company's compliance programs. KPMG points out that, as a result of the "radical transparency" resulting from widespread use of social media, company values and commitment to integrity are "on display as never before."
7. Make the most of the audit committee's time together—effectiveness requires efficiency. In order to make sure that audit committee meetings are streamlined and devoted to substantive issues, KPMG suggests quality pre-meeting materials (and an expectation that they are in fact read), consent agendas, and "reaching a level of comfort with management and auditors so that financial reporting and compliance activities can be 'process routine' (freeing up time for more substantive issues facing the business.)"

Comment: These current issues lists can serve as a useful check for audit committees as they formulate their agendas and identify matters they want to raise with management and the independent auditor. Each company's circumstances are of course unique, but the topics PwC and KPMG have flagged are worth considering.

The Conference Board Reports on Corporate Sustainability Practices and Disclosures, While BlackRock's CEO Links "Positive Contribution to Society" and Long Term Value Creation

The Conference Board Sustainability Center (TCBSC) has issued [Sustainability Practices 2017 Key Findings](#), its annual report on corporate sustainability practices. The Conference Board is a global, independent business membership and research association the mission of which is to "provide the world's leading organizations with the practical knowledge they need to improve their performance and better serve society." The TCBSC report focuses on sustainability, or environmental, social, and governance (ESG), disclosure practices of a broad group of public companies by comparing the ESG disclosures of the companies that comprise the S&P Global 1200, the S&P 500, and the Russell 1000.

The 2017 report finds that sustainability reporting “continues to transition from an exercise in transparency to a more targeted and strategic mechanism for companies to engage with stakeholders.” These stakeholders are urging companies to provide more focused information, rather than simply more quantity: “Rather than broadening the scope of their disclosure, companies are increasingly urged to report on sustainability practices that are more relevant and material to their specific lines of business. This transition is resulting in higher-quality data that are enabling investors and other stakeholders to make better informed decisions about companies’ full range of risks and opportunities.”

Specific “key findings” include:

- “The practice of assuring sustainability reports is becoming more widespread, signaling the growing expectation from stakeholders for access to reliable, consistent, and high-quality nonfinancial data.” (Almost 40 percent of the S&P Global 1200 obtain third-party assurance of the information in their sustainability reports. For S&P 500 companies, 15 percent include assurance.)
- “More than half of S&P Global 1200 companies have adopted a climate change strategy, yet only 16 percent are publicly disclosing the specific risks that climate change poses to their businesses.”
- “Recognizing the key role incentive compensation can play in driving performance against sustainability targets, the number of companies linking executive compensation to ESG performance continues to increase.” (Almost 20 percent of S&P Global 1200 companies disclose that they tie compensation to ESG performance. However, the report notes that “the absence of standard methodologies and low levels of transparency mean there are wide variations in the application of this practice.”)
- “Sustainability disclosure is not making much headway among S&P Global 1200 companies in the health care sector.” (Health care was the only sector with a decline in disclosure compared to 2013. The report notes that the explanation may be that this sector contains a relatively high number of U.S. companies, and “these companies have historically been less exposed to international pressure to report on nonfinancial impacts.” The sector with the highest disclosure rate was Materials.)
- “Compared to North American companies, European companies in the S&P Global 1200 are more than four times as likely to disclose the share of women holding management positions.” (However, despite their high levels of disclosure on this issue, the share of women holding management positions at European companies (22 percent) is below the percentage (25 percent) at North American companies.)
- “A larger share of charitable giving is becoming increasingly concentrated among a smaller subset of companies.” (Three percent of companies accounted for over half of total contributions in 2017, as compared to 5 percent in 2013.)

The increase in company ESG disclosures is being driven in part by the demands of institutional investors and investment managers. In his [2018 annual letter to CEOs](#), Larry Fink, the Chairman of the world's largest investment manager, BlackRock, Inc., called for broader corporate disclosure concerning corporate social responsibility. Mr. Fink asserted that “[t]o prosper over time, every company must not only deliver financial performance, but also show how it makes a positive contribution to society. Companies must benefit all of their stakeholders, including shareholders, employees, customers, and the communities in which they operate.” He added:

“Without a sense of purpose, no company, either public or private, can achieve its full potential. It will ultimately lose the license to operate from key stakeholders. It will succumb to short-term pressures to distribute earnings, and, in the process, sacrifice investments in employee development, innovation, and capital expenditures that are necessary for long-term growth. It will remain exposed to activist campaigns that articulate a clearer goal, even if that goal serves only the shortest and narrowest of objectives. And ultimately, that company will provide subpar returns to the investors who depend on it to finance their retirement, home purchases, or higher education.”

Mr. Fink stated that BlackRock would be engaging the companies in which it invests in dialog on this issue and that, to make that dialog productive, “companies must be able to describe their strategy for long-term growth.” Accordingly, he called on CEOs to “publicly articulate your company’s strategic framework for long-term value creation and explicitly affirm that it has been reviewed by your board of directors.”

“The statement of long-term strategy is essential to understanding a company’s actions and policies, its preparation for potential challenges, and the context of its shorter-term decisions. Your company’s strategy must articulate a path to achieve financial performance. To sustain that performance, however, you must also understand the societal impact of your business as well as the ways that broad, structural trends – from slow wage growth to rising automation to climate change – affect your potential for growth.”

Comment: Both Mr. Fink’s letter and the TCBSC report (along with many other surveys and reports – see, e.g., [Institutional Investors Say They Use ESG Disclosure, But Aren’t Satisfied with What They are Getting, April 2017 Update](#)) make clear that companies are under increasing pressure from mainstream institutional investors to provide concrete, quantified information concerning ESG issues and how they impact the company’s long term economic sustainability. As ESG or sustainability reporting becomes more common (and possibly more regulated), audit committees will need to devote more of their time and attention to oversight of the content of, and controls over, this type of disclosure.

PCAOB 2016 Inspections Status Report

The PCAOB has released the public portion of the 2016 inspections reports with respect to three of the four largest U.S. accounting firms. The three reports that have recently become available are [Report on 2016 Inspection of Deloitte & Touche LLP](#), [Report on 2016 Inspection of Ernst & Young LLP](#), and [Report on 2016 Inspection of PricewaterhouseCoopers LLP](#). No 2016

report has yet been issued with respect to KPMG. The results of the 2016 inspections of D&T, PwC, and E&Y are summarized in the table below.

<u>2016 Big Four Inspections (Reports Issued in 2017)</u>				
<u>Firm</u>	<u>Report Date</u>	<u>Engagements Inspected</u>	<u>Part I Deficiencies*</u>	<u>Percentage</u>
Deloitte & Touche	November 28, 2017	55	13	24%
Ernst & Young	December 19, 2017	55	15	27%
PwC	December 19, 2017	56	11	20%

* The PCAOB describes deficiencies that are included in Part I of an inspection report as "of such significance that it appeared to the inspection team that the Firm, at the time it issued its audit report, had not obtained sufficient appropriate audit evidence to support its opinion" on the financial statements or on internal control over financial reporting in all material respects.

After the PCAOB has made all of the 2016 Big Four firm inspection reports publicly available, the Update will present an overview of the PCAOB's inspection findings concerning these firms.

On December 29, the PCAOB also released its [Report on 2016 Inspection of Grant Thornton LLP](#), another large accounting firm subject to annual PCAOB inspection. In its 2016 inspection of Grant Thornton, the PCAOB reviewed portions of 34 public company audits. The report describes Part I deficiencies in eight (24 percent) of those engagements.

Comment: Audit committees should discuss the results of the firm's most recent PCAOB inspection with their engagement partner. If the company's audit is mentioned in either the public or nonpublic portion of the inspection report, the audit committee should understand the reasons for the reference to the audit and how it will affect the engagement in the future. If the company's audit is not cited in the report, the audit committee should explore with the auditor how deficiencies identified in other audits might have affected the company's audit and how changes in the firm's procedures might affect future audits. Audit committees should also have an understanding of how the firm intends to remediate quality control deficiencies described in the nonpublic portion of the report.

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